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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/168

10:00 a.m., December 16, 1991

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	A. Raza, Temporary
	Deng H., Temporary
	C. M. Towe, Temporary
	J. M. Abbott, Temporary
	V. Kural, Temporary
	G. H. Spencer
R. Filosa	
	A. F. Mohammed
	J. A. Solheim
	K. Ishikura, Temporary
	B. Esdar
	T. Sirivedhin
	P. L. Rubianes, Temporary
J.-P. Landau	
A. Mirakhor	
	L. J. Mwananshiku
	P. Wright
	Z. Trbojevic
	A. R. Ismael, Temporary
	E. Martínez-Alas, Temporary
A. Végh	

J. W. Lang, Jr., Acting Secretary
B. J. Owen, Assistant

1. U.S.S.R. - Technical Cooperation Agreements with Republics . . Page 3
2. Pakistan - Exchange System; Structural Adjustment Facility - Third Annual Arrangement; and Purchase Transaction - Compensatory and Contingency Financing Facility - Fluctuations in Cost of Oil Imports . . . . Page 3
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Also Present

IBRD: R. M. Bendokat, Europe, Middle East and North Africa Regional Office. Exchange and Trade Relations Department: J. T. Boorman, Director; Y. J. Cho, M. A. El-Erian, S. Kanesa-Thasan, G. R. Kincaid, B. E. Rourke. Fiscal Affairs Department: S. N. Erbas. Legal Department: F. P. Gianviti, General Counsel; P. L. Francotte, J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; Z. Iqbal, M. D. Knight, S. Rizavi, S. K. Wajid, M. Yaqub. Secretary's Department: A. Jbili. Treasurer's Department: A. W. Lake. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: P. Bonzom, L. E. Breuer, M. B. Chatah, L. Dicks-Mireaux, B. R. Fuleihan, A. Gronn, M. J. Mojarrad, S. von Stenglin. Assistants to Executive Directors: B. Abdullah, T. Berrihun, J. H. Brits, T. P. Enger, S. K. Fayyad, A. Giustiniani, K. M. Heinonen, P. K. Kafle, R. K. W. Powell.

1. U.S.S.R. - TECHNICAL COOPERATION AGREEMENTS WITH REPUBLICS

The Chairman noted that letters had been received from the Russian Federation and the Republic of Belarus indicating a wish to conclude agreements allowing the Fund not only to extend technical assistance, as provided for under paragraph A.6 of the Special Association with the U.S.S.R., but also to conduct Article IV-like consultations. Similar interest had been expressed by other republics, for instance, Ukraine, in contacts with visiting staff missions. A proposal would be circulated to the Executive Board later that day, for approval by lapse of time, authorizing him to agree, on behalf of the Fund, to requests for all or part of the services referred to in paragraphs A1 to A5 of the Special Association agreement (SM/91/242, 12/16/91).1/ Fast-moving events might overtake the need for such agreements, but it seemed wiser to regularize the conduct of such consultations.

2. PAKISTAN - EXCHANGE SYSTEM; STRUCTURAL ADJUSTMENT FACILITY - THIRD ANNUAL ARRANGEMENT; AND PURCHASE TRANSACTION - COMPENSATORY AND CONTINGENCY FINANCING FACILITY - FLUCTUATIONS IN COST OF OIL IMPORTS

The Executive Directors considered the staff report on the request by Pakistan for the third annual arrangement under the structural adjustment facility (SAF), and Pakistan's request for a purchase relating to an excess in oil import costs under the compensatory and contingency financing facility (CCFF) (EBS/91/191, 11/21/91; and Sup. 1, 12/16/91). They also had before them a policy framework paper (PFP) for the period 1991/92-1993/94 (EBD/91/307, 11/20/91; and Cor. 1, 12/13/91).

The Managing Director had circulated the following statement for inclusion in the record:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole of the Executive Directors of the Bank and IDA in their meeting on December 10, 1991.
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> The Committee of the Whole reviewed the third policy framework paper for Pakistan on December 10, 1991. The Directors noted with approval the Pakistan Government's commitment to adjustment and commended the Government for the progress made in implementing the structural reform program as described in previous policy framework papers and for extending the reform efforts to new areas not originally included in the adjustment program. These steps

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1/ Decision adopted by lapse of time on December 19, 1991, and recorded in EBM/91/171 (12/20/91).

should strengthen economic competitiveness and encourage private economic activity, especially exports and investment, both foreign and domestic.

Directors stressed the importance of sustained improvements in the fiscal position through tax reform efforts and continued restraint in current expenditures. They emphasized the need for continued structural reform in the tax area to broaden the revenue base, including the need to explore ways to ensure that the agriculture sector bears a fair share of the tax burden. Directors also underscored the need to carry through with both structural reforms and demand management to reach the current account deficit target by 1992/93.

Directors supported the Government's efforts to increase development spending as a share of GDP, in particular in view of Pakistan's large investment needs in basic education and health services and infrastructure. They emphasized the need to carefully review the investment program and to further clarify priorities. The Directors also noted the Government's commitment to contain military spending and urged further attention to the tradeoff between nonproductive and development expenditures.

Executive Directors reiterated their strong concerns about Pakistan's poor social indicators and noted recent efforts by the Government to prepare a social action program in time for the next Consortium meeting as well as policy and expenditure measures to address the most urgent issues, including administrative efficiency and improving the allocation of resources. They emphasized the urgent need to implement the social action program. Noting the very high population growth rate of 3.1 percent per annum, the Directors also emphasized the need to strengthen the country's family planning program. They also noted the importance of implementing the Government's environment strategy.

Directors commended the Government for the reform initiatives taken in the last year to privatize public enterprises and to deregulate private sector industrial activities. Directors also noted the progress made in the privatization process of industrial enterprises and commercial banks.

The staff representative from the Middle Eastern Department noted that the Pakistan authorities had notified the staff of two recent policy changes. First, the Government had authorized the Water and Power Development Authority (WAPDA) to levy a surcharge on electricity rates, which would initially be 2.5 percent of the basic tariff, effective from December 1, with additional increases of the same amount in both February and April. The authorities estimated that those increases would yield about Prs 1.75 billion.

Second, in view of a weakening in international market prices for cotton and cotton yarn, the authorities had recently reduced the excise duty on cotton yarn and the export duty on raw cotton, the staff representative stated. Those measures, taken by themselves, would have some negative impact on fiscal revenue, which the authorities expected to be largely offset by an increase in receipts on account of a higher volume of raw cotton exports, because output was expected to be significantly higher than had been projected at the beginning of the year.

With respect to expenditure, the staff representative from the Middle Eastern Department said that the provincial governments had recently implemented further spending cuts that added up to a little over Prs 3 billion for 1991/92, as a result of measures to which general reference had been made in the staff report before the details had been fully worked out.

The Chairman remarked that during their retreat on December 12-13, Executive Directors had agreed on a further streamlining of the Executive Board's work methods. Although the new procedures would not be applied formally until the beginning of January, it might be a good idea to have them in mind for the remainder of 1991.

Two basic agreements had been reached, the Chairman continued. First, the total time for lead speakers would be limited to one hour, which meant that six lead speakers would have ten minutes each, although if several circulated statements, there could be more lead speakers. It was understood that if by 12:00 noon on the day preceding the meeting there were more than six lead speakers, the Secretary would notify each of them so that their statements could be reduced in such a way that they would speak for no more than one hour. Incidentally, that procedure would have applied to the seven lead speakers on Pakistan, who might wish to limit themselves voluntarily to 8 1/2 minutes. Second, following the responses by the staff, other speakers--and there were ten on Pakistan--would be entitled to speak for up to three minutes.

Mr. Mohammed made the following statement:

> Despite the difficulties created by the Middle East crisis, overall macroeconomic performance in Pakistan during 1990/91 was satisfactory in several areas. Abstracting from the adverse effects of the crisis, which caused a sharp deterioration in Pakistan's terms of trade, the balance of payments outcome was close to the program target. Real GDP growth strengthened, export growth was strong, and domestic price pressures showed signs of easing. The present Government embarked on a forceful program of structural reform aimed at stimulating the supply side of the economy and expanding the role of the private sector. As Directors noted during the Board's discussion of the 1991 Article IV consultation in June (EBM/91/80, 6/14/91), some of these structural initiatives went significantly beyond what had been agreed in the context of the three-year structural adjustment arrangement. In addition, despite severe pressures on the

external liquidity position, the authorities pressed ahead with their trade and payments liberalization measures, met all their external debt obligations in a timely fashion, and managed the exchange rate in a prudent manner.

Fiscal and monetary developments were, however, less favorable. On the fiscal front, there were shortfalls in both tax and nontax revenues in 1990/91 owing mainly to the crisis in the Middle East, domestic political developments, including the reluctance of an interim government to take timely economic decisions that might have helped mitigate the effects of the crisis on the fiscal position, and other nonrecurring factors. The staff takes the view that the shortfall in revenues was also due to weaknesses in tax administration. The evidence is not conclusive as it is difficult to disentangle the various factors which combined to affect adversely the fiscal position especially toward the end of the year. Reflecting the deterioration in the fiscal position, and given the difficulties experienced in marketing government debt to nonbanks, money and credit growth was well above target rates.

When the authorities examined the extent of the slippage in the fiscal position in 1990/91, it became clear that the ambitious package of measures embodied in the 1991/92 budget would not be sufficient to reduce the overall fiscal deficit to the targeted 4.8 percent of GDP. Accordingly, in a determined effort to ensure that the macroeconomic and structural reform program remained on track, the authorities implemented a number of significant supplementary postbudgetary measures. The details of these measures are well described in the staff paper. Suffice it to say that the actions taken and the commitments made by the authorities provide assurance that the structural adjustment program's objectives are attainable. The year 1991/92 is also expected to see a surplus in the primary fiscal position for the first time in many years. Reinforcing the actions on the fiscal front, the authorities have implemented a stringent monetary program aimed at mopping up the excess liquidity that had built up in the latter part of 1990/91.

Given the strength and comprehensiveness of the program being implemented, the prospects for the medium term are for a sustainable current account deficit and a movement to a relatively comfortable reserve position. The staff notes some risks in the projections, particularly with regard to exports. While not necessarily disagreeing with the view that Pakistan might encounter protectionist barriers to a rapid expansion of its exports, the staff's assumptions of export growth are actually quite modest: an average nominal rate of growth of a little over 9 percent per annum is lower than would be indicated by the historical elasticity of exports to GDP. Given the recent upgrading of equipment by producers that is leading to better quality products and, hence, higher export unit values, and considering the breakthrough that Pakistan has made into new markets, exports could well perform much better than presently projected.

Developments in the first quarter of 1991/92 suggest that the program remains broadly on track. Preliminary figures indicate an external current account deficit of $334 million compared with $489 million in the corresponding period last year. Monetary policy has been quite tight, and the Government remains committed to lowering the net domestic assets of the State Bank to the end-year target level through weekly auctions of treasury bills and federal investment bonds. The Government is preannouncing its borrowing requirements and will allow sufficient interest rate flexibility to ensure that its cash needs are met from the auctions. There are indications that the restrictive stance of financial policies is bearing down on domestic inflation: according to the sensitive price index, a good leading indicator of inflationary pressures in the economy, prices were 6 percent higher in November than in the corresponding month last year.

The Government's ambitious privatization program is making good progress. In the industrial sector, of the 102 public sector industrial enterprises offered for sale so far, bids have been received for 83 units and letters of acceptance have been issued for 24 units. In the banking sector, two of the five nationalized commercial banks have been privatized and bidding for the third is under preparation. The Government will ensure that a comprehensive regulatory framework will be in place by the end of the year to bring bank and nonbank financial institutions under the supervisory regime of the State Bank of Pakistan.

Mr. Mirakhor made the following statement:

The staff report, the PFP, and Mr. Mohammed's helpful statement provide a comprehensive overview of recent developments as well as a detailed analysis of demand management policies in Pakistan. Demand management is, of course, very important, and the attainment and maintenance of internal and external financial balances is an essential prerequisite for sustained economic growth. Equally important, however, are the supply-side structural reforms that strengthen the foundations for increased savings, investment, and output expansion. In my view, the most significant development in Pakistan in the last year has been the implementation of very comprehensive and far-reaching supply-side structural reforms, including privatization, denationalization, deregulation, and trade and price liberalization. These measures, along with policies to reduce the budget deficit and effect structural fiscal and monetary reforms, have created the preconditions for medium-term, growth-oriented adjustment.

The most striking feature of recent economic and financial developments in Pakistan has been its excellent record of sustained economic growth and price stability. An average growth rate of about 6 percent has been maintained for the last six years, while inflation, whether measured by the GDP deflator or by consumer prices, has been kept to about 7 percent a year. On the financial side, in spite of pressures emanating from external developments beyond the control of the country, prudent fiscal and monetary policies have been pursued. Current expenditures have been reduced from 20.2 percent of GDP in 1987/88 to 18.7 percent in 1990/91, and an attempt has been made to sustain the level of development expenditures in the range of 6-7 percent of GDP. The revenue/GDP ratio was also quite steady, except in 1990/91, when extraordinary and nonrecurring developments reduced it to a below normal level. The staff has given several reasons for this shortfall. What is important, however, is that it was this factor which was mainly responsible for the increase in the overall fiscal deficit in 1990/91; otherwise, the steady decline in the deficit/GDP ratio of the preceding two years might have continued. Moreover, if interest payments, over which the Government has no control, are excluded, it is clear that the fiscal deficits have been quite modest in the last several years. Incidentally, one of the reasons for the revenue shortfall is the Middle East conflict, and I wonder whether the staff has any estimates of the direct and indirect impact of this conflict on the budget in 1990/91. Be that as it may, the Government, fully aware of the need to pursue a tight budgetary policy, has taken steps to further reduce the overall deficit by about 4 percentage points of GDP in 1991/92. As Mr. Mohammed has pointed out, at this level, the primary fiscal position will, for the first time in recent years, show a surplus of somewhat less than 1 percent of GDP.

In the external sector, the impressive growth of exports reflects tight demand-management policies, an efficient program for export promotion and import substitution, as well as a flexible exchange rate policy. Notwithstanding the adverse balance of payments effects of the regional conflict and the setback to aid flows, as mentioned by the staff and Mr. Mohammed, Pakistan continued to meet all its financial obligations on time, and persevered with the trade liberalization measures programmed under the structural adjustment arrangement as well as with further liberalization of the exchange system. Pakistan's achievements, impressive as they are, reflect the determined pursuit of sound economic policies by successive governments. In particular in 1990/91, a year characterized by a change of government, a major crisis in the region, disturbances in and around the country, and the disruption in aid and in the program under the structural adjustment arrangement, the Government persisted in its adjustment effort, although any and all of the above factors had the potential to derail the process of reform. The fact that the country persisted in what the managing director had referred to in his recent address in Lahore as the "courageous implementation" of a comprehensive adjustment program in very difficult and challenging circumstances is a confirmation of Pakistan's commitment to reform.

The main thrust of adjustment policies in Pakistan is aimed at a massive restructuring of the economy based on private initiative and a market-determined pricing system as well as the containment of demand. As mentioned by Mr. Mohammed and the staff, the Government has begun to disengage itself from economic activities that can best be left to the private sector. However, not only is the scope of the private sector being expanded, the regulatory environment also is being relaxed to allow investment decisions to be based on competition and rational analysis. Even the essential services, like utilities, that are expected to remain in the public sector are being organized on a commercial basis with price adjustment being an integral part of the process of reorganization. These are very significant steps that should facilitate the achievement of the medium-term objectives of the PFP, based as they are on the increased role of the private sector. However, I was somewhat puzzled to note from Table 1 of the PFP that the ratio of private saving to GDP is projected to decline by about 2.4 percentage points in 1991/92, and the government/private sector investment ratio is projected to move in favor of the Government, although one would expect that the recent policy reforms should move these ratios in the opposite direction.

Supply-side reforms have been reinforced with both structural reforms on the demand side and tight demand-management policies. Particularly significant is the reduction in the deficit of 4 percentage points of GDP in 1991/92. Some of the policies adopted to achieve the fiscal targets, which involve steep increases in prices of sensitive commodities and services, have potential social and political implications. Measures to reduce the deficit are being further reinforced with structural reforms in the monitoring of expenditure, pricing of energy, agricultural inputs and output prices, and improved tax administration, with lasting favorable budgetary implications. It is reassuring to learn from Mr. Mohammed's statement that performance in the first quarter of 1991/92 indicates that the program is on track and that most of its objectives and targets are on the way to being realized. From a medium-term perspective, it appears that the target of an overall fiscal deficit of around 5 percent of GDP is considered by the staff to be consistent with the medium-term price and balance of payments objectives. This inference is drawn from Table 1 of the PFP, which sets the target for fiscal deficits for 1992/93 and 1993/94 at the same percentage of GDP as in 1991/92. I agree with this target, because I believe that a lowering of the deficit below that level would be deflationary and could impede economic growth. Incidentally, I noticed that grants have been treated as financing rather than revenue items in the case of Pakistan. I was under the impression that normal practice is to treat grants above the line, and the different treatment of grants, of course, has implications for the magnitude of the deficit.

Fiscal policy is being supported by tight credit ceilings with the objective of reducing growth in private liquidity to about 13 percent in 1991/92; it is expected to be contained in the neighborhood of 12 percent per annum thereafter. While I support the tight stance of monetary policy, I was struck by the apparent lack of a meaningful relationship between the growth of broad money and the rate of inflation, as evidenced by Table 1 of the PFP. There can, of course, be several explanations for this: it may reflect leads and lags or it may be that price-determining factors, are more complex in Pakistan. However, if prices are not mainly determined by monetary factors, to the degree that the observed relationship between monetary expansion and prices is weak or statistically insignificant, financial programming for stabilization would raise some potentially intriguing policy questions in the case of Pakistan. I wonder whether the staff has undertaken any study on the precise relationship between prices and monetary expansion in Pakistan, since, given the observed relationship, it would appear that relating precise and specific inflation targets to equally precise and specific targets of monetary expansion under the program would require some underpinning analytic justification. In the context of financial sector reform, I strongly support the staff's call for strengthening the supervisory environment, which is essential if financial sector liberalization is to proceed in an orderly fashion without endangering the stability of the financial system. I would also urge the authorities to take advantage of the opportunity being provided by the reform process to allow rates of return in the financial sector to be market determined and closely reflect rates of return in the real sector. Together with much enhanced supervision, this should permit the reinvigoration, further development, and strengthening of Islamic banking in whose system-wide adoption the Islamic Republic of Pakistan is a pioneer.

While commending the authorities on their bold and comprehensive adjustment program, based on deregulation and an increased role of the private sector as well as a tight demand-management stance, the importance of several other aspects of economic development needs emphasis. I will briefly mention only a few. First, growth must be widely dispersed and broadly shared by all segments of the population and all regions of the country. Social cohesiveness, which is a prerequisite for further growth, cannot be achieved or maintained without an equitable distribution of the fruits of development. Second, the provision of basic needs to all is a necessity in a developing country like Pakistan. Food, shelter, education, and basic medical care need to be provided at reasonable costs; it may be necessary to increase expenditures on these items within the overall fiscal objectives. Third, increased reliance needs to be placed on the domestic resource mobilization effort as a source of financing development so as to reduce dependence on highly volatile external assistance. While fiscal policy should be geared to the mobilization of real resources, due consideration should also be given to achieving vertical and horizontal equity. This is possible through an effort to devise a fiscal system that discourages conspicuous consumption and encourages savings and investment. Moreover, the focus should shift from increasing statutory rates and expanding the tax network to increasing the effective yield through improved tax administration and the discouragement of tax evasion. Fourth, in this rapidly changing world, increased regional economic cooperation and a regional approach to economic problems may be of paramount importance.

With these remarks, I am pleased to support the decision.

Mr. Wright made the following statement:

After a period of serious slippage, the Pakistani authorities have adopted a number of welcome measures in the structural reform program which has been in place since November of last year. The delayed General Sales Tax has finally been introduced; an extensive privatization program initiated; domestic petrol prices raised; investment controls reduced; and the trade and payments system significantly freed up.

At the discussion of the 1991 Article IV consultation report in June, I urged the staff and the authorities to develop a new macroeconomic program that could be supported by Fund resources, and that was at least as ambitious in its objectives as the last structural adjustment arrangement, which had gone off track during the previous fiscal year. More remains to be done, but the developments I have outlined represent a most welcome start, and I can support the proposed decision.

In order to capitalize on the structural reforms, it is necessary for the authorities to foster a stable and sustainable macroeconomic environment. At center stage in the new program will be fiscal policy. I was pleased to see that the new program aims to keep the target for the overall fiscal deficit in the current financial year at 4.8 percent of GDP. The staff describes this target as "ambitious but attainable," and I agree with the assessment.

Achieving this target and--equally important--improving on it in the following years will mean early implementation of measures to reduce exemptions and widen the tax base, while at the same time reducing reliance on taxes on international trade. It will be necessary to monitor closely both federal and provincial revenues and expenditures. There will be no scope for delays in implementing the revenue-raising measures, not least because the rather substantial wedge which presently exists between tax and nontax revenue seems certain to narrow in future.

I continue to be concerned about the extremely low level of direct taxation in Pakistan, and the lack of responsiveness of tax revenue to income growth; I wonder whether the staff could elaborate a little on the causes, and what is being done to alter the situation. I note that it is planned to reduce direct tax exemptions and bring greater taxation to the informal sector, but I wonder whether the problem is being addressed with sufficient urgency. The authorities will also need to extend direct taxation to the agricultural sector, which I see is to be done "at the earliest feasible date." Perhaps the staff could comment on when this is likely to be and whether it has any estimate of the impact of taxation of agriculture on the budget. I think that the authorities need to show much greater resolve on this important issue.

The need significantly to increase government revenue is underlined by the high projected growth in overall expenditures. I have to say in this connection that I found the presentation on page 59 of EBS/91/191 somewhat unclear, but it looks as though development expenditure is projected to rise back above defense expenditure, though both are growing in real terms. The implications seem to be, first, that enhanced revenue is a matter of high priority, and second, that the authorities will need to keep a close eye on their priorities. Development spending should be targeted at creating an environment and infrastructure conducive to the growth of the private sector, but should not of course be seen as a substitute for private sector activity.

Fiscal policy will have to be supported by tight monetary policy, and some progress has recently been made in this area. Nonetheless, I would urge the authorities to press ahead quickly to move to a more market-based system of monetary control. While monetary growth over the coming year does not look excessive in relation to nominal GDP, I wonder whether the staff is entirely happy with the fact that some element of monetary financing is set to continue, notwithstanding the intended repayment of ad hoc treasury bills.

A much greater element of flexibility in the yields of auctioned government securities will be essential in improving monetary control. I found the section of the report that dealt with this a little bit unclear and I have a couple of questions about the government bond market more generally. First, I was perplexed by the discussion on page 26 of the report of the apparently unsatisfactory response of the commercial banks to the new auction arrangements; in particular, I was very unclear about the role of the ceiling on their holdings, and perhaps the staff could explain. Second, I very much welcome the efforts that are being made to promote the development of a secondary market in government securities, but wonder whether the decision to impose a tax on government debt might not serve either to inhibit this development or to increase the cost of government borrowing. The latter development would, of course, negate the effect of the new tax to some extent.

Turning now to the external sector, there is, I believe, a very strong case for using the exchange rate more as a nominal anchor in the attempt to reduce inflation. The arrangements described in the staff report look like a fairly explicit attempt to target the real exchange rate. This is unlikely to be helpful in getting inflation down, and it is unclear that it will help much in maintaining competitiveness. External competitiveness will need to be maintained through firm control of domestic costs. And it goes almost without saying that the authorities should resist all temptation to engage in competitive devaluation, especially if the current projections for export growth prove optimistic. Notwithstanding Mr. Mohammed's reassurances, I am concerned that this could actually turn out to be the case, for example, if the staff's assessment of the effect of recent developments in India on Pakistan's competitiveness proves too sanguine. In any event, the staff must ensure that the advice being given to the Pakistani authorities is consistent with that being given to other major competitors in the region, and I am sure that that will be the case.

To return briefly to the question of export growth, and in view of the information provided by the staff representative from the Middle Eastern Department, I wonder whether the staff could indicate what the impact on the program would be if exports were not to grow at the rates envisaged, and, indeed, whether the authorities have developed any contingency plans to cope with the domestic effects of a series of larger than expected current account deficits.

One of the important conditions for a purchase under the oil element of the CCFF is that domestic energy prices should be allowed to reflect international price levels. In other words, there should be no subsidy. In the case of Pakistan, it is certainly true that domestic energy prices are adjusted on the basis of developments in international markets. But prices are still set by the Government, which leads to delays and irregular adjustments. If the delay is typically shorter for price reductions than it is for increases, then on average a subsidy will remain. Perhaps the staff could confirm that there is no such underlying subsidy. For that matter, it is not clear to me what is to stop energy prices from being completely liberalized.

Having said this, I am content with the staff calculations and, subject to the staff's comments on this question of pricing, I can support both the purchase and the proposed third annual arrangement under the SAF.

Finally, I recall that in June the staff indicated that the Pakistani authorities had expressed an interest in an ESAF program. I wonder whether the staff, or Mr. Mohammed, can let us know what their current thinking is. There would seem to be a strong case for beginning negotiations on such a program as soon as feasible, with a view to introducing an enhanced structural adjustment arrangement ahead of the next fiscal year, which starts in July.

Mr. Al-Jasser made the following statement:

The structural adjustment program before us today is both impressive and ambitious; indeed, it is very strong by the usual standards of the SAF. In late 1990, the authorities launched a revamped structural reform initiative which is far more aggressive and extensive than was originally envisaged under the three-year program. Already, many measures have been implemented under this new initiative, and the authorities are pressing ahead with the implementation of further measures, notably in the exchange and trade system and financial sector. The structural reform effort is being underpinned by a considerable fiscal consolidation effort during 1991/92 which will more than reverse the slippages that occurred in financial policies during 1990/91. The combination of demand management policies and structural reform that is in place augurs well for Pakistan's future economic prospects. The authorities are to be commended for their impressive policy efforts, and I have no hesitation in supporting the proposed decisions.

I will focus my remarks on the demand-management elements of Pakistan's adjustment program. I do so because success in this area is essential for Pakistan to reap the full rewards of its substantial structural reform effort. Broadly speaking, the program envisages an upsurge in private sector activity that would absorb the slack created by a sharp withdrawal of fiscal stimulus. Overall, economic growth would remain strong while inflation decelerated, on the basis of a large swing in public sector savings. Attainment of this virtuous combination presents the authorities with a demanding challenge. In this regard, the authorities' forceful start on tightening financial policies is praiseworthy.

Of course, as the adjustment process takes hold, care will be needed to ensure that neither a markedly lower rate of growth nor an acceleration in inflation is triggered. This underscores the need to monitor the program's implementation closely, and to take corrective measures when necessary, to ensure the overall success of the program. That being said, it will be important to maintain a restrained stance in demand-management policies to ensure that the reallocation of resources and potential inflows of external resources fostered by the ambitious structural reforms do not unleash unwanted inflationary pressures. A move in that direction would risk undermining much of the progress achieved toward financial stability, which is necessary to nurture new investment and to maintain international competitiveness.

The fiscal adjustment targeted for 1991/92 matches the authorities' structural reform program in its ambitiousness. While I agree with the staff's view that this target is attainable, the very size of adjustment does call for a close monitoring of developments as they unfold. In this respect, I am encouraged by the prompt action taken by the authorities in July to introduce additional measures in response to the 1990/91 budgetary outturn, which could have placed the fiscal target for 1991/92 at risk. As regards revenues, the tax reform measures should provide a durable improvement in the revenue base of the budget. I would, however, note that the new capacity tax is likely to prove relatively inelastic with respect to nominal GNP. 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 greater flexibility in yields is introduced in the treasury bill auction markets.

Fiscal restraint will hold the key to the success of the authorities' monetary and credit policy. The reduction in the budget deficit will allow for a larger allocation of credit to the private sector to finance new activities stimulated by ongoing structural reform measures. Fiscal consolidation also will allow greater flexibility in yields to be introduced in the auction markets for government securities without placing strong upward pressure on interest rates that could prove unduly disruptive to the private sector. On the subject of financial sector reform, I share the staff's views on the need to move ahead expeditiously in the supervision of the financial system. Also, I would like to emphasize the need for government securities to be sold in open markets at market-clearing rates of return. In this regard, I am pleased to note the recent action taken by the Government in this direction, which is described in Mr. Mohammed's helpful statement, action that also will facilitate an early move toward a market-based system of monetary control.

Turning to exchange rate policy, I would appreciate some clarification from the staff. While I agree with the recommendations contained in the staff appraisal, some of the statements made earlier in the staff report appear to be inconsistent.

Specifically, on page 29 it is said that "exchange rate management will be directed at maintaining the real effective exchange rate at about the average level prevailing during the period June-August 1991." One sentence later we are told that the nominal effective exchange rate is expected to be sustained within the narrow range experienced during 1990/91 through firm demand-management policy. In view of the projected rate of inflation for 1991/92, are these statements consistent?

The Government's privatization plan is proceeding at a very rapid pace and will impart a powerful impulse to the private sector's participation in the economy. I welcome the authorities' intention not to use nonrecurrent privatization proceeds to fund budgetary expenditures. This is a prudent practice, and I hope that it will continue beyond the current fiscal year. However, as the authorities recognize, the proposed disposition of the revenues from privatization will have a stimulative effect on the economy. This stimulus should not be allowed to compromise the macroeconomic objectives of the adjustment program. Perhaps the staff could provide some estimates of the timing of the privatization receipts, the amounts involved in relation to GDP, and the nature of any offsetting policy measures that might be required.

In light of our recent informal discussions on Board procedures, I would encourage the staff to keep its reports brief and concise.

In conclusion, my comments are given in the spirit of trying to contribute to the success of a program that is impressive in its ambitions. The authorities deserve much credit for the strengthened vigor they have introduced into Pakistan's structural adjustment effort, and I wish them every success in their endeavors.

Mr. Towe made the following statement:

In many respects, the progress made since the Board's approval of Pakistan's structural adjustment arrangement in 1988 has been extremely satisfying. That a number of important structural reforms were implemented and that macroeconomic growth was robust, despite a deterioration in the terms of trade, a change in government, and regional border tensions, is gratifying. Thus, we concur with the comments of the previous speakers in this regard and can agree with Mr. Mohammed's description of the third annual arrangement as strong and comprehensive. Nonetheless, it seems unfortunate that many of the important objectives that were originally envisaged for the third year remain elusive. On the macroeconomic front, the latest targets for the current account deficit, domestic inflation, gross domestic savings, and official reserves for 1991/92 are clearly weaker than those in the revised program of two years ago. More significantly, many of the program's important structural reforms have been postponed to the indefinite future.

Perhaps the most disappointing aspect of the final year's program is the fact that fiscal adjustment has again fallen short of expectations. In particular, we find it difficult to reconcile the statement in the staff's June report that the 1991/92 fiscal budget measures deviated significantly from the objectives of the structural adjustment program, with the latest description of the budget as an ambitious and major structural reform effort.

For example, while the original fiscal deficit target of 4.8 percent of GDP has been maintained on a cash basis, the staff rightly acknowledges that the target is ambitious on the basis of the authorities' budgetary and postbudgetary measures. Indeed, given the historical inelasticity of Pakistan's tax system, the program's assumption of a significant increase in tax revenue as a share of GDP before the measures are taken suggests an obvious risk of shortfall. Moreover, the fiscal target relies on a number of temporary factors, which suggests that the structural deficit is even higher. First, the prepayment of one month of civil service salaries--equivalent to 0.4 percent of GDP--artificially lowers the 1991/92 figure. Second, it would appear that nontax receipts in 1991/92 are likely to be temporarily boosted by the payment of interest arrears by WAPDA. Third, it would seem that a number of subsidy and other expenditures--in particular those that are being financed by privatization receipts and the Welfare Fund--have been placed off budget. In this latter regard, could the staff indicate what scope there would be for increasing the transparency of such transactions and placing them on budget?

While the risk to the original program's overall fiscal target is a concern, the concurrent delays in the program's structural fiscal reforms are more important. In particular, the continued weakness in the fiscal revenue system--as suggested by the fact that 1991/92 tax revenues are expected to be a full percentage point of GDP below the original SAF projection--has contributed greatly to the weakened pace of fiscal adjustment. It is unfortunate, therefore, that the staff's earlier assessment--that the 1991/92 budget's direct tax measures do not represent a comprehensive package for reforming income taxation, and that they fall short of the SAF program's original objectives--appears to remain valid. While the staff takes comfort from the authorities' intentions to eliminate income tax exemptions next year, and to tax the agricultural sector at the earliest possible date, the authorities' piecemeal approach on these issues to date provides little assurance that these intentions will be translated into effective action.

Moreover, notwithstanding the important progress made with regard to the reform of the indirect tax system--including the tariff reform and the introduction of the General Sales Tax (GST)--the staff's earlier critical assessment of the indirect tax measures also still appears valid. For example, the insignificant incremental yield that the GST-related budget measures are expected to provide in 1991/92 strongly suggests that little progress has been made in addressing issues related to the registration of firms and the scope of exemptions. Thus, it is difficult to see how the GST represents a significant improvement--either in terms of its elasticity or its efficiency--over the previous sales tax.

Perhaps the most disturbing evidence of the continued weakness of Pakistan's revenue system relates to the introduction of a consultative excise system--in which taxpayers are able to negotiate their tax liability with the authorities. This measure seems more likely to institutionalize the pervasive corruption of the existing tax system than to contribute to the objectives of the structural adjustment arrangement.

Finally, expenditure discipline has been an important element of the arrangement since its inception. In this regard, it is disappointing that total defense expenditures remain well above 6 percent of GDP. We acknowledge that these outlays must be cast in a regional context. We also acknowledge that the published data include the interest paid to foreign creditors to finance imports of weapons, and therefore overstate somewhat the amount of current outlays on defense. Nonetheless, Pakistan's disturbingly high rate of infant mortality, and the weakness in its other social indicators, strongly suggest that this level of defense expenditure reflects a severe misallocation of resources, and highlights the need to improve spending on the social sector.

Turning to monetary issues, the original structural adjustment arrangement had laid an important emphasis on financial reform. It is disappointing, therefore, to note that the evolution to a market-based financial system appears to have been further delayed. That the authorities continue to prefer direct credit controls over individual banks, rather than operating their monetary policy through more indirect instruments, suggests that a stronger effort in this area is required. In particular, we cannot help but wonder whether the authorities continue to be unwilling to allow rates of return to increase to the level necessary to allocate credit efficiently.

We applaud the increased emphasis on bank supervision and control, as well as the efforts to privatize the banking sector. Nonetheless, it was surprising to note that the authorities are attempting to promote a minimum capital adequacy ratio of only 3 percent, which would appear to be well below recent international norms of 8 percent. The issue would appear to be important since the apparently weak balance sheets of the nationalized banks and the large provincial cooperatives suggest that there may exist a substantial contingent claim against the Government. Could the staff offer some comments on whether it views this level to be appropriate?

Finally, the staff and Mr. Mohammed's assessment that external sustainability is in reach is extremely encouraging. Yet, as the staff notes, the balance of payments remains vulnerable to external shocks. In that light, would the staff or Mr. Mohammed indicate whether the authorities expect to request that discussions begin on a possible arrangement under the ESAF? If so, it would be our hope that many of the disappointments of the current arrangement could be avoided through a greater front-loading of the many structural reforms that are still required.

Mr. Landau made the following statement:

During recent years, Pakistan has enacted a broad set of far-reaching and ambitious structural measures, especially since November 1990. The trade regime has been liberalized; domestic investment has been deregulated; and the reform of the financial system and monetary management has been implemented. At the same time, Pakistan has been hit by the consequences of the Middle East crisis, which amounted to a terms of trade shock and a negative impact on GDP of around 1.2 percent. These effects have been partially matched by strong fiscal action by the Government, in the form of expenditure restraint and tax increases representing approximately 2 percent of GDP, but they also led to a larger than expected deficit and monetary financing.

In this framework, I shall deal successively with the program on public finances, some aspects of monetary policy, and the external financing needs of Pakistan during the next few years.

On structural reform of the public finances, the central objective of the third annual program is to broaden the tax base so as to bring government revenues to a level more compatible with the trend in expenditures. The aim is to raise the level of those revenues from 14 percent to 20 percent of GDP, an aim that, however warranted, is indeed very ambitious, and that raises several main questions.

First, on the expected distribution of public revenues and expenditure between central and local government authorities, I understand that some shifting of responsibilities is expected, under the program, toward local authorities. I would appreciate some comments as to the possibilities for controlling and limiting slippages at the local level in the future.

It is certainly welcome that the program envisages a shift from import taxation to more neutral and less distortive sources of revenue. However, it seems that most of the gains recently made have consisted of increases in excise duties and user fees. I would be happy to know whether this trend is expected to persist or whether apart from the increase in the GST, direct income taxation can be envisaged to a greater extent. By the same token, I understand that the staff is expecting that a significant part of the increase in revenue might come through better tax administration, whereas Mr. Mohammed does not seem to find much room for progress in this field. I would appreciate some comments.

But the central question I have is the following: are the structural reforms in public finances and macroeconomic objectives totally consistent? An increase in taxes of about 6 percent of GDP (with public expenditure stable at approximately 25 percent) will have both demand- and supply-side negative effects on growth. GDP is nevertheless projected to increase by more than 6 percent a year, while the current account deficit is to be reduced to 2.5 percent of GDP in the next three years. Very strong assumptions must have been made about export growth and competitiveness, which might be justified owing to Pakistan's recent performance, but whose realization appears to be crucial to the success of the program. I would appreciate staff comment on the sensitivity of the overall results and balance of payments to a lesser growth of exports in the two years to come.

My last question, about privatization, relates to the quantitative contribution that is expected to be made to the reduction of the fiscal deficit.

I have only one comment on monetary policy. The staff appraisal incorporates the customary recommendation to move to a market-based system of monetary control; in the case of Pakistan, the staff urges the authorities to do so at an early date. On the other hand, it seems from the report that, apart from reducing monetary financing of the budget deficit, most of the efforts will rely upon direct credit controls or administrative intervention on the monetary base, such as the imposition of special deposit requirements. It also seems that, although the first steps toward the establishment of a wide market for treasury bills have been taken, it will be a long time before it can be seen as an efficient framework within which banks would manage their liquidity. Finally, structural changes such as privatization will occur, as well as an expected reinforcement of prudential supervision. The general feeling is that it will take some years to introduce the structural conditions for effective, market-based monetary control, and that, in the meantime, it would be appropriate for the authorities to keep direct mechanisms in place, unless they are to run the risk of losing control of monetary expansion. But I would certainly appreciate comments by the staff in this regard.

On exchange rate policy, I understand that the staff recommends targeting the real exchange rate so as to keep it at its summer 1991 level, which is considered appropriate. Apart from the naturally inflationary bias of such a strategy that is now much recognized, I have one question: to what extent would this strategy be affected by what is happening in India? And conversely, as India's effort to maintain a stable nominal exchange rate is being supported, what would be the consequences for the latter country if its real exchange rate appreciates against Pakistan's? Maybe the respective exports of the two countries are not close substitutes, so that the need for a consistent approach of their exchange rate policies is not that great. But it is also stated in the policy framework paper that depreciation in India could impede Pakistan's growth. Maybe the staff would also comment on this aspect. I am sure we all agree on the need for some consistency in our advice; indeed, the systemic responsibility of our institution is, at the very least, to ensure that countries do not harm themselves by engaging in noncooperative strategies of competitive devaluation.

We fully support the purchase under the CCFF. It will be, I understand, Pakistan's last purchase under the 1990 decision on the oil import element, which expires at the end of 1991. I would appreciate staff confirmation of this view. But the purchase has to be seen in the broader framework of Pakistan's external financing. As the staff report makes clear, Pakistan will continue to need significant amounts of external financing in the years to come, especially taking into account the burden of interest on its debt. Given this prospect, I wonder whether the staff could comment on prospects for future support by the Fund, for instance, under the ESAF. I would also note that owing to the CCFF purchase, the Fund will provide the bulk of multilateral financing for Pakistan this year. The World Bank group, in the three years to come--including IDA credits of $755 million--has a disbursement objective which appears reasonable and appropriate. However, Bank disbursements for the coming years are projected at only $225 million, which does not seem totally compatible with the overall objective; thus, I would appreciate comments by the staff. This being said, let me reaffirm the strong support of my authorities for the program and wish the Pakistani authorities well in their endeavors.

Mr. Esdar made the following statement:

I am pleased to note that Pakistan has embarked on a new adjustment effort in the framework of the third annual structural adjustment arrangement in order to overcome its economic imbalances. Policy slippages as well as external factors over the last two years have led to the derailment of the stand-by arrangement and to the postponement of the third annual arrangement under the SAF.

The delays in adjustment and in the structural reform process have aggravated the balance of payments position, hampered economic prospects, and thus increased the need for appropriate policy reactions. Therefore, I fully support the view of the staff that these imbalances have to be addressed by a comprehensive, convincing adjustment program. Tight demand management in this regard is of crucial importance in order not to jeopardize the success of structural reform. With respect to the necessary policy adjustments, I can support the general thrust of the staff appraisal, perhaps with some modifications.

Generally, I am somewhat under the impression that growth objectives have been the main driving force for this program. I wonder whether a somewhat less ambitious growth objective would have facilitated the task of monetary policy and strengthened the process of internal and external stabilization.

On fiscal policy, a reduction in the overall fiscal deficit from 8.8 percent of GDP in 1990/91 to 4.8 percent in 1991/92 seems to be a very ambitious objective. However, the staff has estimated that even without any corrective measures, the deficit would have been in the range of 6.9 percent. In addition, in my view, the targeted figure of 4.8 percent is somewhat misleading as it can only be achieved by shifting a certain share of wage payments to the previous fiscal year.

In view of the not very efficient tax system, fiscal adjustment relies heavily on revenue-increasing measures. However, the potential to cut expenditures should not be neglected. In this regard, I have noted with some concern that the share of economically unproductive expenditures will not be reduced significantly.

With regard to the tax system, long-standing structural weaknesses have been the main reason for fiscal deterioration in the past. Therefore, the authorities are well advised to adopt--without any further delay--a comprehensive structural reform in the fiscal sector. The main emphasis should be on reducing tax exemptions significantly. In this regard--and here I quote the staff report--"to extend the scope of taxation in the agricultural sector at the earliest feasible date" in my view seems to be not a very binding or ambitious commitment. Generally, I wonder what might be the rationale for the huge share of tax exemptions in the agricultural as well as in the industrial sector.

To add another point, we welcome the authorities' intention to reduce the reliance on taxes on international trade. However, when reviewing the so-called additional budget measures, I was surprised to note that a considerable share of the revenue measures is related to trade. I wonder whether this outcome is compatible with the announced policy reform.

Taking all these fiscal elements together, in my view, a strengthening of actions would support the stabilization efforts. I, therefore, welcome the additional fiscal measures being announced today.

On monetary policy, the reduction of the inflation rate from 10.7 percent in 1990/91 to 8 percent in 1991/92 seems to be a somewhat gradualistic approach. I wonder whether this course of action is sufficient to break inflationary expectations, especially given the exchange rate policy which--and here I quote again--"is expected to provide sufficient incentives to sustain the recent strong expansion of exports and also to help in containing the demand for imports." A tighter monetary policy combined with a nominal exchange rate anchor would, I believe, be a more appropriate policy course.

To conduct a more efficient monetary policy--and here I fully support the staff's view--it is of utmost importance to introduce, without any delay, market-oriented instruments, and to provide for more effective management of an auction system for treasury bills. An effective and deep-rooted liberalization of interest rates is the most appropriate way to achieve sufficiently positive real interest rates. As for the interest rate situation, I have noted that all interest rates, even those on concessional credit schemes, are targeted to be positive. I wonder whether I could have a more detailed description, especially with respect to the role of concessional credit schemes and the present interest rate structure.

Furthermore, given the Government's excessive financial recourse to the State Bank of Pakistan, I wonder why no ceiling has been set under the program for budgetary financing by the State Bank of Pakistan.

Finally, on trade reforms, after three years of structural reforms in the trade sector, it is not very encouraging to note that the maximum ad valorem tariff rate is envisaged to be reduced just to 90 percent in 1991/92. In this respect, I fail to see a major reform effort, all the more as Pakistan's tariff structure remains very much on the protectionist side compared with that of other countries.

To conclude, the agreed program provides a framework for macroeconomic and structural adjustment, perhaps with some room for further strengthening. However, given the understanding that the authorities will use any available room to strengthen their efforts, I can support the proposed decisions.

Mr. Raza made the following statement:

We commend the Pakistan authorities for having put into place a bold, comprehensive, and far-reaching program of macroeconomic stabilization and structural reforms. On present indications, this has given a new lease of life to the entrepreneurial class and put the economy back on the track of sustained rapid growth. As many Directors noted at the time of the last discussion on Pakistan in June, and have repeated today, the broad range of reforms undertaken by the authorities--reform of the financial sector, an extensive program of privatization, delicensing of investment decisions, liberalization of the exchange rate and the trade and payments system, and encouragement given to foreign direct investment--have gone much beyond the objectives of the structural adjustment arrangement. The results have been truly encouraging. It is a matter of record that, despite serious domestic problems and a not very conducive external environment, output grew by 6.5 percent in 1990/91--among the highest rate recorded by developing countries. The path chosen by the authorities was uncharted and difficult. On many points, they slipped--and slipped badly. They have, however, shown the resolve and determination to take necessary corrective measures--many of which involve hard, difficult, and unpopular decisions--and go ahead with the program. The medium-term objectives the authorities have set before themselves may seem somewhat ambitious. But the track record of the present Government gives me reason to believe that they will achieve them.

Developments in the economy during 1990/91, including measures taken by the authorities, are detailed in the staff report. The staff has also presented its vision of the economy in the short- and the medium-term: what can be achieved, the problems that may arise, and the actions that will need to be taken to overcome them. I am in general agreement with the staff analysis of the current situation, its assessment of the medium-term outlook, and the recommended policy package. I will therefore limit myself to a few short comments, raising a few issues and seeking elucidation on a few points.

It is generally agreed that fiscal imbalance and ineffective demand-management policies have been at the root of the problems facing the Pakistan economy. The situation remains a cause for serious concern even today. The concern arises from last year's experience, which was anything but confidence inspiring. The authorities have no doubt taken substantial measures to correct the fiscal imbalance. We note, in particular, the widening of the income tax base, broadening of the GST base, improvement of the system of excise taxation, and the tightening of the administration of taxes on international trade. These measures, in the words of Mr. Mohammed, provide assurance that the program objectives are attainable. Certainly, the objectives are attainable;

the question is whether they will in fact be attained. The current position with respect to revenue realization, the expenditure level, and the primary deficit vis-à-vis the comparable position last year may throw some light on this matter. Would Mr. Mohammed or the staff provide the necessary data in this regard? Further, as tight expenditure control is central to achieving the fiscal objective, the staff may like to indicate its assessment of the effectiveness of the machinery set up to monitor Government expenditure.

While on the topic on fiscal reform, I would like to seek two more clarifications from the staff. First, on the need and/or justification for introducing taxation in the agricultural sector at the earliest feasible date, I wonder how the staff justifies its recommendation--on grounds of intersectoral equity or revenue? If the former, I would be interested in some empirical evidence. The measure can, of course, be justified on grounds of interpersonal equity--and also as a means of plugging one way of evading, or rather avoiding, the payment of income tax. But there are many other ways of tackling the issue. I am not against taxing the agricultural sector--in fact, I am for it. However, given the politically sensitive--in fact, explosive--nature of the issue, the legal complications, and serious conceptual problems in estimating agricultural income, I would suggest treading that path cautiously rather than making a hurried attempt to implement the measure at the earliest feasible date. Second, I would also be interested in knowing whether and to what extent the proposed elimination of the tax credit for investment would affect investment decisions and therefore growth prospects.

The need for continued tight monetary policy can hardly be overemphasized. The central issue seems to lie with the large-scale and unrestricted monetization of the fiscal deficit that has led to large monetary expansion and the generation of inflationary pressure. While measures have been taken to popularize government paper among nonbanks, there is no clear evidence to indicate either that they have taken to this paper or that they will take to it in the immediate future. In the meantime, the monetary measures announced in October--the increase in the discount rate, the imposition of a special deposit requirement, and the withdrawal of refinancing of bank advances against cotton--while effectively reducing bank liquidity and helping stabilize the net domestic assets of the State Bank of Pakistan will only cut down the flow of credit to the private sector. These measures thus do not address the main issue, which is the banking sector's support of the fiscal deficit. While on this point, I would have thought the imposition of a ceiling on banks' holdings of government paper to be a good idea and its subsequent withdrawal a retrograde step. The staff, however, seems to have welcomed the withdrawal, which in my view, is no way of inducing banks to invest in Federal investment bonds. I would appreciate elucidation from the staff on this point. In the same vein, I find that net domestic financing and net domestic assets of the State Bank of Pakistan are proposed as quantitative benchmarks, and net domestic assets of the banking system as an indicative target for the proposed third annual SAF arrangement. Would it not have been advisable also to have a ceiling on credit to the Government by the State Bank and/or banking system as one of the quantitative benchmarks or indicative targets?

I strongly support the staff's call for the development of secondary markets in government securities with a view to instituting a market-based system of monetary management.

On the exchange rate, we encourage the authorities to continue with the flexible policy, which has already paid rich dividends. However, as emphasized by the staff, exchange rate flexibility should not be taken as a substitute for the strong, firm, fiscal and monetary policies needed to restrain aggregate demand. The latter, rather than competitive devaluation, should also be the route taken to preserve international competitiveness and achieve external viability. The fiscal deficit, if allowed to persist and financed by recourse to central bank credit, will be reflected in a balance of payments deficit, whatever the stance of exchange rate policy.

The staff has pointed to the adverse effect of the recent devaluation of the Indian rupee on exports from Pakistan. Both Mr. Landau and Mr. Wright have commented on this point. In this connection, I may only point out that, with the abolition of all subsidies on exports, the devaluation of the Indian rupee itself should not pose any threat to Pakistan.

To conclude, the authorities have shown commendable determination to take hard decisions as part of the program of macroeconomic stabilization and structural reform. The international community must support them in their effort. It is in this context that I support the authorities' request for the third annual arrangement under the SAF in an amount equivalent to SDR 109.3 million. I also support their request for a purchase amounting to SDR 122.4 million under the CCFF.

I wish the authorities well in the difficult task before them. Mr. Landau commented that he had posed his question on the exchange rate not so much from the point of view of the impact of the rupee devaluation on Pakistan, but from the opposite viewpoint. The fact that India would have a policy of nominal exchange rate stability meant that in the future, Pakistan's exports could harm India's exports as much as the contrary might have been true in the past. The question ran two ways.

The staff representative from the Middle Eastern Department noted that the direct impact of the Middle East crisis on the fiscal position in 1990/91 could be attributed mainly to the effect on revenue of receipts from petroleum and natural gas development surcharges. Those receipts had been much lower than expected, both because of the sharp rise in international prices of petroleum and petroleum products, and because the authorities had been reluctant to make a corresponding increase in domestic prices until November 1990. The result had been a reduction in receipts in 1990/91, from the expected level of 1.9 percent of GDP to 1.2 percent of GDP. Domestic energy prices were currently consistent with prices prevailing in international markets, and there were no subsidies on internationally traded energy products. The pricing of energy products in Pakistan was not fully flexible, and as Mr. Wright had suggested, a specific fixed rate of taxation on various traded petroleum products would have the advantage of eliminating the need to fix prices administratively.

The grants that had been received from Saudi Arabia and the United Arab Emirates--an in-kind grant of petroleum and a financial grant, respectively--had been made for the purpose of temporarily meeting the additional budgetary costs of the Middle East crisis, the staff representative explained. For that reason, the staff had included the grants as a below-the-line financing item.

The budgetary shortfall also reflected an additional salary payment made at the end of the fiscal year, amounting to some 0.4 percent of GDP, the staff representative noted. In addition, there had been delays in clearing items through customs in expectation of a reduction in customs duty in the 1990/91 budget. As a consequence, the disposable income of the private sector had been higher than it would have been otherwise, and private saving had risen to 16 percent of GDP in 1990/91.

The large adjustment in the public sector's current fiscal position of 4.3 percent of GDP under the program resulted in large part from the noncollection of taxes in preceding years, the staff representative observed. The adjustment envisaged policy measures to reduce government spending on items that constituted subsidies for private consumption. The staff assumed that part of the increase in government saving would be offset by a fall in private saving, even if in the longer term the program would exert a positive effect on private sector saving. While the staff hoped that the savings performance of the private sector would be somewhat better than programmed, it had seemed realistic to make a more conservative assumption for the current fiscal year. The small rise in the ratio of government public to private sector investment reflected the coming to fruition of certain large, capital-intensive, infrastructural projects undertaken by the Government, particularly in the power sector, despite the larger participation of the private sector. The World Bank staff had felt strongly that those projects should be adequately funded so that they could be brought on stream, especially as the result would be a substantial contribution to the future growth of private sector activity, including the production of nontraditional exports.

In past years, direct taxation had yielded less than 2 percent of GDP, a low ratio even for a developing country with the income level of Pakistan, the staff representative observed. The large number of exemptions from direct taxation had also affected the elasticity of the tax system, including the exemption of agricultural income and exemptions granted to foster industrial investment in rural and backward areas. As a result, the authorities had been obliged to take significant discretionary measures in the area of direct taxation just to maintain a constant ratio of direct tax revenue to GDP.

The ratio of direct tax revenue to GDP would increase significantly in the current fiscal year, the staff representative added. The measures that had already been taken included the turnover tax, which applied to all firms even if they were exempt from standard income tax; a reduction (by about 30) in the number of tax exemptions in September; and introduction of a new fixed tax on small business. In the area of indirect taxation, significantly greater efforts had been made to identify firms that should be subject to the General Sales Tax (GST). The authorities were committed to ensure that either the GST or excise taxes would cover most large-scale domestic production and imports in the near future. In addition, many postbudgetary measures had been taken with a view to restraining expenditures. In the context of the program, the authorities had committed themselves to increase the ratio of revenue from direct taxes to GDP. It had been increased by 0.4 percent of GDP in the current fiscal year, and it would be raised by at least 0.25 percent of GDP in each of the two succeeding fiscal years. That was one reason why the structural content of the authorities' budgetary tax package had been found, upon detailed examination, to be more substantial than appeared to be the case at the time of the Board's discussion of the staff report for the 1991 Article IV consultation, in June (EBM/91/80, 6/14/91).

Nevertheless, further improvements in direct taxation must be made, including gradual removal of the large number of exemptions introduced in an attempt to foster various types of activities, the staff representative observed. The staff would also welcome the extension of taxation to the agricultural sector at the earliest feasible date. The direct taxation of agricultural income was not a federal prerogative under Pakistan's constitution. Nevertheless, the federal authorities had attempted to extend taxation in some areas of agrobusiness. The exemption of agricultural income was considered to be an important issue because at present taxpayers could shelter nonagricultural income and reduce their legitimate tax liabilities. In this connection, the National Finance Commission Award, which had recently come into effect, should provide provinces with an increased incentive to extend taxation in some areas because the provinces were now allowed to keep any additional revenue to increase development expenditure. At the same time, the provincial governments were being constrained from running deficits because under the same Award the Federal Government no longer had to finance provincial deficits with nonobligatory grants.

Under the new arrangements introduced by the National Finance Commission Award, it was important that the provincial governments would receive a larger share of the pool of tax revenue than in the past, the staff representative explained. The provincial governments had a major responsibility for social sector expenditures, for instance, on education and health, where substantial spending increases in real terms would be needed over the next few years. The ultimate mechanism of provincial expenditure control would be their inability to borrow from the Federal Government.

A fiscal adjustment of the size projected on the basis of the recent measures to increase revenue would have some impact on the rate of growth, the staff representative remarked, although real wages were more flexible in an economy like Pakistan's than in an industrial economy. The growth rate for 1991/92 was projected to be approximately 6.2 percent, although in the previous year when external factors had not been conducive to buoyant activity, the growth rate had actually been 6.5 percent in real terms. The major engine of growth would be strong export performance, which was continuing, although some tapering off in the rate of export growth was assumed as a result of the increasing protectionist pressures that textile exports might encounter in markets where Pakistan's share was growing. By and large, although the projections for export growth were fairly high, they were lower than in recent years and should be achievable.

The target of 4.8 percent of GDP for the overall fiscal deficit for 1991/92 on a cash basis reflected an amount equivalent to 0.4 percent of GDP for 1991/92 salary payment that had been made just before the end of 1990/91, the staff representative commented. Including this amount, the fiscal deficit would be 5.2 percent. In part, the fact that the fiscal deficit was larger than previously programmed reflected a higher level of development spending particularly on several large electricity generating projects that were close to completion. Also, relative to the revised projections that had been included in the program under the second annual arrangement, the level of international interest rates was now projected to be somewhat lower, and Pakistan's export growth had been much more buoyant than had been expected at that time. While a substantial effort would be required to achieve the overall fiscal deficit target for 1991/92, the target was consistent with a move to medium-term external viability. That did not mean, however, that further fiscal adjustment would not be needed in future years, especially if international economic conditions proved to be weaker than assumed in the program under discussion.

As for the relationship between the increase in monetary aggregates and the growth of nominal GDP in the program for 1991/92, the staff representative explained that in the discussions with the authorities it had been agreed that an effort should be made to absorb the monetary overhang that had been apparent toward the end of the previous fiscal year, early in 1991/92, when the authorities would be making large repayments on short-term international debt and the pressure on reserves would be greatest. Consequently, the projected rate of growth of money and credit, at 12.9 percent, was lower than the expected 14.7 percent rate of growth of nominal GDP at the targeted inflation rate. Those projections might be consistent with a somewhat better inflation performance, at least by the end of the year, than was being targeted under the program.

The velocity of money was, of course, being affected by the ongoing financial sector reform, the staff representative continued. In moving to a system of market-oriented monetary management, it would be crucial for the authorities to establish markets for auctioning treasury bills and long-term federal investment bonds. Substantial progress had been made in that direction over the past year, and once the markets were established--which the staff believed could be in the not-too-distant future--it would be possible for the State Bank of Pakistan to control domestic credit by entering into transactions in the market for government securities. The first requirement was full flexibility of rates of return in the auctions, so that the State Bank could determine the rate at which it wished to increase high-powered money independently of the amount of government borrowing. Recently the authorities had allowed much greater flexibility in rates of return but it could still be increased further. Second, there was a need for the Ministry of Finance to implement the framework for forecasting its cash needs and the amount of securities to be issued. A Fund expert had been working in Pakistan for nearly two years on the development of financial markets and on the forecasting framework; accordingly, it should soon be possible for the authorities to operate a market-based monetary policy.

While the quantitative ceilings on bank credit would need to be maintained for some time, they should eventually become redundant, the staff representative noted. For that reason, the program included a benchmark on the rate of growth of the net domestic assets of the State Bank as the monetary control mechanism, and a benchmark on total net domestic financing. If banks were buying government securities in an open market, it did not seem appropriate to have a ceiling on total bank financing of the budget deficit as a benchmark in the program, and that target was therefore set as an indicative one. The authorities' determined effort to move to market-based monetary management had a good chance of succeeding, provided they would allow full flexibility of rates of return in the recently introduced government securities markets. The ceiling on bank holdings of government debt would indeed be inconsistent with such a move, and the staff would welcome its elimination in due course.

In alluding to the real exchange rate target, the staff representative said, the key element of the program was demand restraint. Provided that monetary and fiscal policies were implemented as programmed, maintaining the real effective exchange rate at approximately its current level should be consistent with strong growth of exports and restrained import growth; during the first quarter of 1991, that had indeed been the outcome. The authorities intended to follow movements in the real effective exchange rate closely, even if the demand-management program was implemented as foreseen, in order, for example, to guard against the risk of appreciation of the rupee and loss of competitiveness if the U.S. dollar rose relative to other important currencies in Pakistan's exchange rate basket. The ceiling in the program was an indicative target and was intended to send a signal if there was any evidence of an appreciation of the real effective exchange rate.

As to the consistency of the staff's statements on page 29 of EBS/91/191 that the real effective exchange rate should be maintained at about the average level during the period June-August 1991, but that the nominal effective exchange rate was expected to remain within a relatively narrow range during 1990/91, the staff representative commented that over the 12 months to October 1991 consumer price inflation had been above the weighted average of Pakistan's trading partners that was used to calculate the effective exchange rate index. Although inflation had been falling in Pakistan, it had declined somewhat more rapidly in partner countries than had been expected. Therefore, it remained to be seen whether the target of not changing the real effective rate too much would be consistent with maintaining the nominal exchange rate in a fairly narrow range. In any event, the reference in the staff report was to maintaining the nominal exchange rate in a narrow range, rather than at a fixed level, the intention being not to allow the real effective rate or international competitiveness to deteriorate.

As the Managing Director himself had noted during his visit to Pakistan, the staff representative from the Middle Eastern Department recalled, full implementation of the program under the third annual SAF from the Middle Eastern Department arrangement would provide a good basis for opening discussions on a program to be supported later by an arrangement under the ESAF. The authorities had already indicated clearly that they would be interested in such a program, on which discussions could perhaps start in the spring of 1992.

Mr. Spencer commented that if a mechanism had been set up to control the net domestic assets of the SBP, with appropriate benchmarks being set, he wondered why it was necessary to keep the bank-by-bank credit ceilings in place. Coming on top of that mechanism, credit ceilings might actually foster dependence on them, thereby preventing the shift to market-determined interest rates in the auction system. Moreover, if a fallback position was desirable to control money and credit, a mechanism based on a ratio would be a more neutral and less distorting method than direct bank-by-bank credit ceilings.

It would also be helpful, Mr. Spencer said, to have the staff's view on whether or not the introduction of consultative and capacity-based taxes on firms would be conducive to reducing corruption in the tax system, or whether it would encourage the negotiation of taxes.

The staff representative from the Middle Eastern Department observed that if the authorities could move quickly to a system of market-based monetary management, the bank-by-bank ceilings could be eliminated at an early date and the distortions to which Mr. Spencer had referred, and which were of concern to the staff as well, could be avoided. In the meantime, the authorities should continue to draw up a credit plan which would ensure that, given a rate of domestic credit expansion consistent with monetary stability and the targeted inflation rate, and given the public sector's need for financing, adequate credit would be available to the private sector. The essential precondition would be full flexibility of rates of return. In that connection, during 1990/91 credit extended to the Government by the SBP had risen too rapidly to ensure monetary stability. The cash reserves of the banks had to be controlled in a way that was consistent with the programmed rate of inflation before the bank-by-bank ceilings on credit to the private sector could be removed.

With respect to indirect taxation, capacity taxation and consultative taxation were not totally novel mechanisms in Pakistan, the staff representative from the Middle Eastern Department stated. Those mechanisms had assumed importance because the weak administration of excise taxes, which had been based on a factory gate clearance system, had led to disappointing performance of revenue from excise taxes for certain important industries. It had therefore become necessary to look at capacity output in order to determine an appropriate level of taxation for these industries. In the longer term, it was true that both capacity and consultative taxation were open to abuse; the authorities had to engage in negotiations with producer groups in order to calculate or agree on tax liabilities, and such taxation was not likely to be elastic in response to output growth. The staff hoped that the two mechanisms would be used only in an interim period while an appropriate tax burden was being assessed, and that a more streamlined procedure could be developed over the medium term.

Mr. Mohammed added that the authorities were not weaned from selective credit controls, and they used bank-by-bank ceilings partly to implement a policy of selective credit allocation. As for indirect monetary control, secondary markets were not yet developed; in addition to a flexible interest rate policy, there was also a need for institutional developments that would allow a full-fledged secondary market to begin to operate. That might take rather longer than the authorities themselves would wish.

Mr. Abbott made the following statement:

> At the time of the Article IV consultation in June, we expressed concern that Pakistan's economic policy had gotten out of kilter and that the momentum for the structural reform had faded. Complete data for 1990/91 confirm that there was a serious erosion of fiscal and monetary discipline. It is particularly regrettable that lapses in macroeconomic policy were concentrated in the areas of the tax structure, revenue administration, and monetary management, all of which had been the focus of earlier structural adjustment efforts.
>
> We are pleased that the Pakistani authorities have now been able to put in place an economic program that could reclaim the ground lost in the previous fiscal year and that proposes redoubled efforts on an expanded agenda of structural reform. We believe the agreed program is an appropriate basis for a third

annual arrangement under the SAF, and we can support the proposed decisions. We can also support the authorities' request for compensatory financing.

The targeted reduction in the 1991/92 budget deficit to 4.8 percent of GDP must be considered the centerpiece of the Pakistani program. Achieving this target requires implementation of many of the structural measures that have long been under way. Failure to achieve a fiscal correction of this order of magnitude would put at risk many of the other objectives of Pakistan's economic strategy, such as cutting inflation, reducing government intervention in the economy, placing greater reliance on private initiative, and strengthening a vulnerable external position. We cannot emphasize too much the need for staying with the program, taking additional measures if necessary, and for continued careful monitoring of the budget situation every step of the way.

The supplementary package that the authorities put in place following the revenue shortfalls of 1990/91 is an encouraging sign of renewed commitment to timely reform measures. On the revenue side, we commend the authorities for the tax measures already implemented this fiscal year, especially those that broadened the base for the income tax and the General Sales Tax. Early implementation of measures to increase the elasticity of excise taxes should also be undertaken. We also welcome the additional fiscal measures planned for 1992/93 to reduce further tax exemptions, to widen the tax base, and to reduce gradually reliance on international taxes.

We fully support the measures planned to reinforce monetary and financial discipline. Bank financing of public sector debt in the last fiscal year was excessive, putting inflation control at risk and limiting the opportunities for private sector expansion. A lower borrowing requirement will lessen this pressure. An effective auction market for government paper, adequate capitalization of banks, and more complete privatization of the banking system, as well as effective banking supervision, are all needed for the exercise of indirect monetary control and for the efficient allocation of credit. We particularly endorse the staff's call for urgent action to establish effective banking supervision.

Developments over the last year have further weakened Pakistan's already vulnerable external position. The low level of reserves and the buildup of short-term debt leave little latitude for slippage or surprises. The program to build up reserves gradually and to work down the current short-term debt exposure must be considered essential elements of the country's economic policy. The very strong export growth of recent quarters provides an encouraging base for expecting that the transition to a more secure external position can be made in an orderly fashion. Indeed, the improved export performance is the strongest possible endorsement for the structural measures which have liberalized trade and increased reliance on private initiative.

Given the vulnerable external position, we believe the policy of sustaining the competitiveness of the exchange rate is appropriate, particularly since it is likely to be achieved in the context of a gradually stabilized nominal exchange rate resulting from the overall orientation of macroeconomic policy. The planned firm stance of macroeconomic policy is designed to bring down internal inflationary pressures and make supply-side improvements by reinforcing the current level of underlying competitiveness. We would be concerned about an attempt to artificially impose nominal stability since, with a weak external reserve position, there would be a strong temptation to maintain the nominal rate by reinforcing a still highly distorted trade regime rather than to continue efforts at liberalization.

We believe that the ambitious export projections in the program are achievable but provide little scope for slippage. Likewise, the growth projections strike us as ambitious, even if achievable. The authorities should guard against relying on best-case projections and be prepared to take prompt corrective measures if developments do not go according to script. We support the suggestion by Mr. Wright and others that Pakistan develop contingency plans in case external developments prove less favorable than hoped.

Mr. Filosa made the following statement:

Let me start by emphasizing that in the case of Pakistan, valuable time has been wasted in the process of macroeconomic and structural reform. Even if one abstracts the effects of difficult political and economic circumstances that the country has faced, the slippages in macroeconomic policies have been substantial. In particular, the larger than programmed overall fiscal deficit, which was the consequence not only of temporary factors but also of serious weaknesses in tax administration and enforcement, and the resulting very high level of domestic financing, can be viewed as the main causes of the acceleration of inflation and of the deterioration of external accounts. This chair, therefore, considers the reduction in the fiscal imbalance as crucial to achieving adjustment.

This leads me to a further consideration. In order to reinforce the budget, the measures taken on the revenue side should be strengthened by equivalent efforts on the expenditure side. To the contrary, however, the ratio of government expenditures to GDP, which for the present fiscal year is expected to increase slightly for the reasons described by the staff, remains approximately constant in the following fiscal years. Hence, no further improvements in the fiscal imbalance are envisaged in the fiscal years from 1992 to 1994. This chair, thus, encourages the Pakistani authorities to strengthen their efforts to constrain current expenditures since fiscal adjustment is particularly necessary in light of the degree of uncertainty surrounding developments in the external accounts. In fact, as recognized by the staff itself, "monitoring of development expenditure at the government level is very weak."

As far as monetary policy and financial sector reforms are concerned, this chair welcomes both the successful efforts by the monetary authorities in bringing the money and credit aggregates back on track and the significant steps taken in order to achieve a market-based system of credit allocation, rates of return, and monetary management. However, as clearly stressed by the staff, an "urgent need is to strengthen the supervision of bank and nonbank financial intermediaries." Let me briefly elaborate on this point. Commercial banks, which are already subjected to a liquidity ratio, are expected to achieve a capital adequacy ratio of 3 percent of callable liabilities by December 1992. This measure, in my opinion, is incomplete. Simplifying the analysis, we can say that liability-side ratios aim to safeguard deposits. But in these circumstances, banks, even though fulfilling this sort of capital adequacy ratios, are not restrained from lending without an adequate assessment of the related risk. In fact, as far as banking supervision is concerned, the current international trend is to resort to asset-side ratios weighted for the risks attached to different types of assets. The adoption of such ratios serves also the purpose of improving the efficiency of financial intermediaries. In the case of Pakistan, the introduction of such an instrument of supervision can be considered particularly relevant in the light of the financial sector reform program, which aims at enhancing private sector banking activities through both the privatization of national commercial banks and the establishment of new banks. Therefore, taking into account the immaturity of local financial markets, one can envisage and welcome the introduction in the near future of a "simplified" risk-asset ratio not only for commercial banks but also for nonbank financial intermediaries. Comments from the staff would be appreciated.

Let me conclude with two comments on the external sector. First, the pace of replacing most of the nontariff barriers by tariffs seems to be rather slow as the process is expected to be completed only by June 1994. I would, therefore, encourage the Pakistani authorities to implement a rapid replacement of the nontariff barriers followed by an equally rapid reduction in the degree of protection in order to increase the degree of competition and foster the efficiency of the economic structure. Second, the commitment on the exchange rate policy seems, in my opinion, rather weak. The authorities should be aware that permanent gains in external competitiveness should be pursued not through the management of the exchange rate but through the implementation of sound domestic policies.

In the case of Pakistan, the case for more stringent macroeconomic policies can easily be made simply by looking at Chart 1, of the staff report. In the years ahead, the fiscal deficit remains constant, as I have already observed; monetary growth is higher than that envisaged in the second year of the SAF program, and the same applies to real growth. On the other hand, the inflation rate, the current account deficit, and gross official reserve accumulation are all expected to be worse than envisaged in the previous arrangement. I wonder why it has not been possible to set targets equivalent to those set in the previous arrangement. I hope that, if a future ESAF arrangement is agreed upon, the Pakistani authorities would aim to regain the ground lost during the last fiscal year. This chair endorses the proposed decisions.

Mr. Spencer said that he agreed with the staff and previous speakers that the policy actions taken over the past six months, together with the authorities' commitments for the future, were sufficient to put Pakistan's program back on track. His chair, therefore, supported the proposed decisions, including the request for compensatory financing. He had only two questions. The first related to the strong export growth that had been achieved in recent years and that was also projected into the future. Mr. Landau, Mr. Wright, and other speakers had highlighted the key role of export growth in the program. In its paper, the staff identified various government supports in addition to the favorable underlying competitive position that were relevant to that export performance. In particular, the staff cited the effects of tax incentives, including duty exemptions and special credits affecting the volume of cotton-based manufacturing exports, forms of support that were further accentuated by a tax on cotton yarn exports. His question was related to the importance of the various forms of support in the strong export performance in the past. If that support had been an important factor, how confident was the staff that the strong export growth would continue in the future, given that such policy distortions were intended to be phased out as part of the program?

Another question related to the prudential area that had already been touched on, Mr. Spencer noted. By all accounts, the recent financial failures had reflected some rather serious problems involving fraud and widespread mismanagement. He wondered what else was being done to rectify those problems, apart from adding a nonbank supervision department to the State Bank of Pakistan. For example, was the Government's bank and nonbank legislation being overhauled to reinforce, for instance, auditing requirements and the duties of directors; which actual prudential requirements were being tightened up?

Mr. Solheim made the following statement:

I welcome the authorities' clear strengthening of demand restraint during the latter half of this year and the presentation of a structural program that appears to extend reform efforts beyond previous undertakings.

Although the staff stresses that the program for 1991/92 has a good chance of bringing the adjustment program back on track, it also recognizes that the actual performance of the Pakistan economy could be weaker than anticipated. Consequently, if the objectives are to be achieved, caution is called for to avoid slippages. The staff correctly emphasizes the need to accelerate the pace of financial sector reform, including the move to a market-based system of monetary policy and an urgent need to strengthen the supervision of banks. The aim of a capital adequacy ratio of 3 percent of callable liabilities by December 1992 is, in an international context, on the low side. It is, however, reassuring to observe from Mr. Mohammed's statement that the Government will ensure a comprehensive regulatory framework under the supervisory regime of the central bank.

According to the staff paper, the authorities are pursuing a flexible exchange rate policy to sustain exports and contain demand for imports. With the decelerating rate of inflation and the strengthening of economic policy, is not the time ripe for using the exchange rate as a nominal anchor to foster price stability?

The authorities are also requesting a purchase under the oil element of the CCFF. As the CCFF calls for a relatively strong program, and the structural reforms in some areas now will extend beyond the authorities' undertakings under the structural adjustment arrangement, I may repeat an observation this chair made in June about whether the authorities should have aimed at a more demanding program, for instance, under an enhanced structural adjustment arrangement. A comprehensive program would have allowed for an even more determined approach, for instance, on financial sector reform.

Furthermore, I note the authorities' intention to implement the program of import liberalization and tariff reform. However, as Pakistan's trade regime remains among the most restrictive in Asia, I should like to have the staff's comments on whether the reform process could have been speeded up further.

I found Chart 1 on economic indicators, which relates program projections to the actual outcome, a comprehensive way of presenting the economic program. A graphic presentation along these lines may be worth using more widely in the Fund's program reviews.

A key to the successful implementation of the program will be firm fiscal policies, where control needs to be exerted over both federal and government expenditures to ensure the objectives of the program. In the memorandum from the World Bank, the Government's commitment to contain military spending is noted. Studying the structural side of the budget, one is struck by the high defense expenditures.

On the revenue side, it is important to improve, through various structural measures, the existing system. Import duties continue to make up the bulk--more than 35 percent--of tax revenue, in a very complex excise taxation system. The recommendations by the recent Fund technical assistance mission on tax policy and administration should be followed up. I support the proposed decisions.

Mr. Ismael made the following statement:

We would like to join previous speakers in commending the Pakistan authorities for significantly strengthening their program of adjustment. We note that the structural and demand-management measures that have been introduced have brought the program back on track after the adverse shocks felt in late 1990 and early 1991. The policies being pursued appear appropriate to ensure the strong and sustainable economic growth in the medium term that is needed to improve the standard of living of the population, without jeopardizing the objectives of reducing inflation and financial imbalances.

In the fiscal area, the authorities have taken a number of new measures to ensure that the fiscal targets will be met. We especially welcome the fact that a surplus in the primary fiscal position is expected during the present fiscal year, as noted by Mr. Mohammed in his statement. However, we would agree with previous speakers on the need for the authorities to maintain their efforts to improve tax administration and to monitor outlays closely. In this context, the information given by the staff regarding the economies realized by the provincial governments is welcome. Nevertheless, we would note that the large fiscal adjustment envisaged under the program will have a severe impact on the more vulnerable groups of the population, and we share the views expressed earlier by Mr. Mirakhor on the need to ensure that these groups are adequately protected, and that sufficient resources are made available for education and health services.

We also note that in support of their fiscal efforts, the authorities have substantially tightened monetary and credit policies, which should help to remove the excess liquidity that had built up earlier this year. We note especially the determined efforts of the authorities to reduce government borrowing from the banking system. These measures, together with the accelerated pace of reform and privatization in the financial sector, should help to make this sector more efficient and more responsive to the needs of the increasingly active private sector. However, care must be taken to ensure that the financial system remains sound, and in this respect we are pleased to note from Mr. Mohammed's statement that a comprehensive regulatory framework to that effect is being put in place.

In the external sector, the measures introduced have resulted in a more open system as well as a higher level of exports. Furthermore, the efforts to improve the quality of products produced in Pakistan, together with the opening up of new markets, indicate that the authorities' optimism about export performance may be well placed and could lead to further strengthening of the external sector, thereby improving the future prospects for external viability.

Overall, the authorities' efforts, which in some cases have gone beyond the program, constitute a clear commitment to improve the functioning of the economy and improve its resilience to exogenous shocks. We agree with the staff that the objectives set are achievable with the policies and measures envisaged, and we can support the request for a third arrangement under the SAF. We can also support the proposed decision on the request for compensatory financing as it appears to meet the requirements under the CCFF decision.

Mr. Ishikura made the following statement:

Under the second annual arrangement under the SAF and thereafter, internal and external imbalances widened, although real GDP and exports showed robust growth. This outcome was due mainly to the relaxed demand-management policy and also to the adverse effects of the Middle East crisis on the fiscal and external positions.

Beginning at the end of last year, the authorities took comprehensive steps to cope with the crisis and to resume economic adjustment. A new General Sales Tax was introduced, and adjustments were made in domestic energy prices and public utility charges. An extensive program of privatization was begun. The exchange and trade system was liberalized, along with continued tariff reform, and an auction system for government securities was introduced. Needless to say, these actions are not sufficient to complete the necessary adjustments in each area, but they do provide an indispensable basis for the implementation of the third-year program. In view of these comprehensive prior actions, we welcome and support Pakistan's third annual arrangement under the SAF.

While I broadly agree with the staff appraisal and the program design, I would like to make two comments for emphasis.

First, program performance depends crucially on fiscal adjustment. While we endorse the planned policy measures in the fiscal area, we attach special importance to cutting back unproductive expenditure, particularly defense expenditure, which makes up 24 percent of total expenditure in 1991/92. From a purely economic point of view, it is quite clear that the reduction of defense expenditure would be the most desirable and effective way to strengthen the fiscal position and ensure the necessary resources for social and development expenditure. As we noted at the time of the 1991 Article IV consultation, we expect, and again urge, the Pakistani authorities to consider cutting defense expenditure.

Second, as a result of the purchases under the third annual SAF and the CCFF, Fund credit outstanding to Pakistan will be around 137 percent of quota. As a rule, if a member with a relatively high level of credit outstanding makes further purchases, it is more desirable if they are phased, based on the observance of performance criteria. However, in this case, the purchases under the SAF and CCFF will be made immediately after the Board's approval, as usual. Therefore, we hope all the more that the authorities will continue their efforts to pursue the planned economic adjustment and to strengthen their external position during the program period. At the same time, we expect that the program review, which is scheduled for the first half of 1992, will be conducted in a timely manner. We share the staff's view that a satisfactory track record under the third annual arrangement under the SAF is a prerequisite for the consideration of an enhanced structural adjustment arrangement.

With these remarks, we support the proposed decisions and wish the authorities well.

Mrs. Sirivedhin made the following statement:

Let me state at the outset that I support Pakistan's request for a third annual arrangement under the SAF and a purchase under the CCFF. My support is based upon the fact that the program for 1991/92 and the medium term, as outlined in the policy framework paper, is reasonably strong and appears adequate to address the current economic and social problems. The program has rightly placed the emphasis on further efforts to foster a reduction in the budgetary deficit, maintaining high economic growth while at the same time reducing inflation, and strengthening the central bank's net external reserves. In addition, the compensatory financing purchase has been necessitated largely by factors beyond the control of the authorities, and the requirement regarding cooperation with the Fund and balance of payments need is met.

Since I am in broad agreement with the thrust of the staff appraisal contained in the staff report, I would like to make only a few general comments.

Despite the adverse external developments, it is encouraging that Pakistan has maintained relatively high growth. It is even more encouraging that the performance of the economy in 1990 was supported mainly by robust export growth, better performance of the industrial sector, and gains in agricultural output. I hope that the growth of these important sectors can be sustained. In particular, I have some concerns on the sustainability of high growth under the program, owing to the persistent saving-investment gap and the uncertainty of the world economic situation, as reflected in the current slow economic growth in industrial countries. In this regard, I am encouraged by the authorities' action to further strengthen their structural adjustment measures on both the demand and supply side, notably, a speedy privatization process, a more liberal investment policy, and a firm commitment to contain the budgetary deficit--moves that are more pronounced than envisaged in the previous program. The authorities' initiatives to create a more liberal economy and expand the role of the private sector will, in my view, gradually enhance Pakistan's self-reliance.

To preserve the benefit gained in recent years, the maintenance of macroeconomic discipline is of utmost importance. On the fiscal front, further reduction of the overall fiscal deficit through enhanced domestic resource mobilization and firm control over expenditures is crucial to achieving macroeconomic adjustment. In this regard, I note with satisfaction that the authorities have taken several measures in 1991/92 that are intended to widen the tax base, enhance the elasticity of the tax system, and strengthen tax administration as well as contain current expenditure. I also welcome the establishment of a National Taxation Commission, which has made comprehensive proposals on the reform and extension of direct and indirect taxes. I hope that the authorities will persevere in maintaining the implementation of tight fiscal policies consistent with the program objectives and avoid any slippages.

On the monetary front, I welcome the progress made in restraining credit and money growth, which should allow the authorities to achieve inflation and balance of payments objectives. In this regard, I am heartened by the authorities' intention to continue the use of more market-oriented instruments of monetary policy, and the privatization of commercial banks, as well as permitting the opening up of new private banks. The obvious next step of allowing interest rates to be determined by market forces would promote the process of mobilizing savings, of which Pakistan is in dire need.

In conclusion, I am confident that the authorities will continue their adjustment-for-growth efforts with commitment and determination. Pakistan has made positive strides in its adjustment efforts. The Fund's continued support is, therefore, of special significance for the success of Pakistan's adjustment program, as it will provide a solid foundation for the continued implementation of its medium-term economic and structural reforms.

With these remarks, I can endorse the proposed decisions.

Mr. Mwananshiku made the following statement:

As indicated in both the staff report and in Mr. Mohammed's statement, Pakistan has implemented important structural reforms under the medium-term adjustment program, including trade liberalization, financial sector regulation and supervision, and investment promotion. Moreover, the economy has continued to grow strongly and export performance was remarkable, particularly in 1990/91.

However, progress toward correcting the fiscal imbalance has been less successful than anticipated. Owing largely to adverse external factors, the recovery of the external sector has been weak, despite the authorities' effort to pursue sound exchange rate policy. Developments partly associated with the Middle East situation had negative implications for both gross domestic investment and tax revenue, which in 1990/91 registered a sizable decline in relation to GDP.

We are pleased to note that following the weak fiscal outcome in 1990/91, the authorities implemented a package of postbudgetary measures in order to keep the program on track. We welcome the intention of the authorities to reduce the budget deficit further to 4.8 percent of GDP in 1991/92 from 8.8 percent in 1990/91. The proposed program of action for 1991/92-1993/94 embraces a wide range of measures--tax reform and expenditure restraint, reform of the system of administered prices, reform of the financial sector, promotion of the private sector and efficient management of the enterprises remaining under government control, and trade and tariff reforms. We urge the authorities to adhere strictly to the proposed program and to respond timely to any developments that may jeopardize its successful implementation.

After these general observations, I would like to make a few specific remarks.

Despite considerable efforts aimed at the diversification of the economy, Pakistan's exports are still heavily dependent on a limited number of commodities whose growth performance in the years prior to 1990/91 was very modest. However, export growth in 1990/91 was over 18 percent. This high rate of growth was made possible not only by the improved external competitiveness brought about by the continued flexible management of the exchange rate and the implementation of new export promotion measures but also by the fact that the export base was narrower in 1989/90. Growth of this magnitude seems difficult to sustain given the uncertainties surrounding the external environment. I would welcome staff comment on this point.

Although the effective rate of protection still appears high, the authorities have already taken commendable steps to reform the trade system and intend to take further measures that will result in a significant reduction in the maximum tariff rate by 1994/95. I would appreciate staff comment on whether the intended measures will enable Pakistan to achieve a desirable effective rate of protection by then.

Finally, Pakistan appears to be making rapid progress in implementing its program of privatization. Bearing in mind the fact that other developing countries have experienced greater difficulties in implementing their privatization policies, I wonder whether the staff or Mr. Mohammed could say a word on why Pakistan is making such rapid progress. For instance, is it due to a robust capital market? With these few words, I support the proposed decision and wish the Pakistan authorities well in their endeavors.

Mr. Trbojevic made the following statement:

I would like to begin by stating my concurrence with the economic policy program of the Pakistan authorities. It is regrettable that the program went off track in the last two years, but clearly the authorities are determined to resume, and even to reinforce, their structural adjustment efforts, and they deserve our support. However, it seems to me that both the budgetary and the external position will remain very weak and fragile for some time. I would like to focus my remarks on these two issues.

On fiscal policy, to be honest, I am still not too convinced that the budget deficit target envisaged for the current fiscal year is attainable. In particular, the substantial shortfall in government revenues experienced last year is worrisome. The staff attributes this shortfall for the most part to serious weaknesses in tax administration, while Mr. Mohammed stated that the evidence is not conclusive. Nevertheless, I would like to raise two questions on this point.

First, referring to Table 3 in the staff report, to what extent is the discrepancy between the authorities' May 1991 projections and the provisional actual outcome for fiscal year 1990/91 of a structural nature, and has this structural component been incorporated in the projection for 1991/92? Although I welcome the authorities' planned measures to improve tax administration, these measures will probably take some time to become effective.

Second, the projected rise in tax revenues will not come from any increases in tariff rates, but from changes in regulations, and by limiting exemptions and introducing new taxes. It is well known that revenues from these kinds of measures are highly uncertain. Is this uncertainty taken into account in the fiscal projections, and how does the staff assess any remaining downward risks in these projections? And how do the authorities intend to react if these risks should materialize?

The fiscal deficit is projected to decline to 4.8 percent of GDP in the current fiscal year, and to stay at that level in the next two years. Although I would like this to happen, it seems to me that the level is still high and, in the longer run, hardly sustainable. But if it is attained, I believe that the authorities should aim at a further reduction of the deficit. Do they have the intention to do so, if not in the next two years, perhaps in the years thereafter?

As for the financing of the projected current account deficit, I noted the strong increase that is expected in the inflow of medium- and long-term capital in 1990/91 of $864 million; and in 1991/92 of $1,384 million. Also, I was struck by the high level of outstanding short-term external debt. Do the staff or the authorities envisage possible risks in relation to external financing, for instance, because of difficulties in refinancing short-term debt, or insufficient foreign assistance? In this respect, it is worth mentioning that in the 1989/90 annual report of the State Bank of Pakistan, it was stated that the gap between commitments of foreign economic assistance and actual disbursements widened.

Despite the uncertainties associated with the macroeconomic projections, I wholeheartedly support the proposed decisions. I hope the program will be a successful one, and I wish the Pakistan authorities the strength to implement it fully.

Mr. Martinez-Alas made the following statement:

Pakistan's overall economic performance under the SAF program has been marked by advances and setbacks; hence, the results to date are mixed, although encouraging. These developments are explained, in part, by severe external shocks; but important policy slippages, delays in implementing measures, and accommodative macroeconomic policies account for more of the unmet benchmarks and performance criteria. We must, however, acknowledge the important prior actions already taken by the Pakistani authorities to put the adjustment program back on track.

We would like to urge the Pakistani authorities to move further and more rapidly toward more ambitious efforts in the steady pursuit of structural adjustment, mainly because Pakistan has already reaped some of the benefits stemming from the structural adjustment process. According to the staff report, "export growth was very strong in 1990/91," and "it was attributable to improved external competitiveness brought about by structural measures implemented during previous years...."

On the fiscal sector, before making some remarks on the tax measures in Pakistan's program, we would like to comment, briefly, on tax reform. On the one hand, we are fully aware of the difficulties of implementing a comprehensive and fully coherent tax system in developing countries. In less developed countries, revenue needs, vested interests, existing taxes, previous commitments, weaknesses in tax administration, and piecemeal reforms, are all obstacles on the path toward more equitable, efficiency-neutral, broad-based, and high-yielding tax systems. On the other hand, we would like to think that there is broad agreement on the basic objective of a tax system, regardless of the country's economic development level: namely, to raise the highest amount of revenue with the minimum of economic distortions. Also, we share the perceived consensus and trend to rely more on broad-based consumption taxes, moving away from direct income taxation and taxes on foreign trade.

In this context, we welcome the long overdue and long delayed expansion of the base of the General Sales Tax. Specifically, we will comment on the exemption granted for fertilizers and pesticides. The economic cost of cleaning the environment is a lot higher than the short-term alternative cost of avoiding technologies that are the source of pollution. Doubtless, the income level of Pakistani farmers needs to increase through higher productivity, and modern agricultural technology is an important source of productivity gains. However, from a long-term point of view, encouraging the use of polluting fertilizers and pesticides through tax exemptions in fact jeopardizes the future prospect of the farmers' well-being, since degraded natured resources will be far less productive in the future. The authorities should not subsidize implicitly, by tax exemptions, the use of agricultural techniques that are known to be a source of environmental pollution.

We also welcome the authorities' intention to reduce the tax system's reliance on international trade; the proposed income tax reform is a step in that direction. However, taxing dividends and interest on financial instruments, including bank deposits, seems to imply double taxation, discourage domestic savings, and introduce distortions in the relative price of financial instruments, moving the tax system away from broad neutrality and equity. We would appreciate further elaboration from the staff or the authorities on this matter. We would also urge the authorities to phase out, in a feasible time frame, all export taxes, so as to include most productive activities in the domestic tax network.

On the financial sector structural reform and monetary policy, we welcome the authorities' intention to allow sufficient flexibility in the rate of return on auctioned government securities. At the same time, we urge the authorities to implement and enforce the regulatory framework of the financial system, especially the much needed strengthening of the supervision of financial intermediaries. Without a competitive and well-regulated financial system, it is not possible to gather and channel domestic savings to productive and efficient investment.

Finally, we share the staff's opinion "that exchange rate flexibility should not be seen as a substitute for needed strong restraint in aggregate demand." Therefore, the use of the exchange rate as a nominal anchor for domestic price stability is highly advisable.

With these remarks, we support the proposed decision and wish the authorities well in their future endeavors.

Mr. Deng made the following statement:

Over the last few years, Pakistan's economic performance has been mixed. With the support of the first annual arrangement under the SAF and the stand-by arrangement, there was considerable early success. Later on, difficulties were experienced in keeping the economic program on track as a result of weakened adjustment and reform measures under the second annual SAF arrangement. Persistent problems in the economy were exacerbated by the Middle East crisis, and the resultant sharp rise in international oil prices contributed to a large decline in the terms of external trade.

In response to a deteriorating situation, the new Government took a number of important measures to speed up macroeconomic adjustment and structural reform. The economic reform program, which was launched later by the authorities, was broadly based and covered areas even beyond the authorities' undertakings under the SAF. Encouraging progress was made on several fronts, particularly with respect to structural reform in the public sector. Furthermore, policy initiatives for 1991/92 show the authorities' strong commitment and perseverance in strengthening the medium-term adjustment and structural reform program which was set in motion in 1988.

I am in broad agreement with the staff's appraisal on economic developments in Pakistan, and I believe that further financial assistance is warranted so that the authorities can sustain their adjustment efforts. Therefore, this chair supports the authorities' request for a third annual arrangement under the SAF and a purchase under the CCFF.

It goes without saying that the current economic difficulties facing the authorities are overwhelming and the task of economic adjustment is formidable. Extraordinary efforts will be needed to ensure that the various policy measures are implemented forcefully and that the ambitious targets are achieved. In particular, the strengthening of demand restraint is essential for a general improvement of the economy. Therefore, the authorities' firm commitment to adjustment policy undertakings is crucial.

In this regard, the implementation of fiscal measures, in particular a strong supplementary package of postbudget revenue and expenditure measures to ensure achievement of the overall fiscal deficit target for 1991/92, is commendable. Sustainable fiscal improvement, however, requires further enhancement of the adjustment efforts, especially as regards structural reform, for which policy initiatives are well spelled out in the policy framework paper.

It is encouraging to learn from Mr. Mohammed's informative and helpful statement that monetary policy has been quite tight and that the authorities remain committed to lowering the net domestic assets of the State Bank to the end-year target level. While flexibility in setting interest rates is welcome, efforts to accelerate the financial sector reform are to be encouraged.

The external sector performance has benefitted from the substantial progress made to liberalize the exchange and trade system and the further deregulation of foreign investment. The authorities should continue with structural measures already in place and devote more attention to the improvement of external viability and reduction of the economy's vulnerability to external and domestic shocks. In this connection, we would like again to emphasize the need for strong restraint in aggregate demand, and the forceful implementation of fiscal and monetary policy measures and structural reform, so as to strengthen the external performance and reach the medium-term program target.

With these remarks in mind, I can support the proposed decisions and wish the authorities success in their future endeavors.

Mr. Kural made the following statement:

Neither the record of Pakistan's economic performance under the first two annual SAF arrangements, nor economic developments in 1990/91, reveal satisfactory results. During 1990/91, in addition to the constraints and bottlenecks that already affected Pakistan's external accounts, the country's internal balance was disturbed by the Middle East crisis. The first manifestation of the crisis, which was indirectly linked to its effect on the balance of payments, involved the squeezing of the international financial markets. The second was in the area of price performance and stemmed mainly from the large increase in the domestic prices of petroleum products, which were driven up by price increases in the world markets.

In the fiscal area, I agree with the staff's view that fiscal adjustment is crucial because government spending is still the critical threat to the adjustment program's ability to withstand external shocks. Fiscal correction has been hampered not only by difficulties in reducing the Central Government's borrowing requirement but also by the weaknesses of the government-owned enterprises. I welcome such recent fiscal measures as the widening of the income tax base, improvement of the system of excise taxation, and the broadening of the base of the GST to achieve the 1991/92 budget deficit target, but I am not sure that these revenue measures are the best way of reducing the borrowing requirement. It might be preferable to downsize the public sector in an orderly fashion, and to seek larger expenditure cuts than envisaged in the program, by applying well-defined spending priorities, for instance, through substantial real reductions of provincial-level current expenditures, wage and salary expenditures, defense expenditures, and subsidies.

Also, I share the staff's doubts that it will suffice simply to monitor budgetary developments and speedily implement corrective measures in order to realize the fiscal objectives. Such measures as enhancing revenues by strengthening tax administration, reducing tax exemptions, and improving the efficiency of taxes on international trade for 1991/92 do not impress me as sufficiently ambitious in the light of the past year's fiscal revenue outcome. In this connection, could the staff comment on Pakistan's taxes on international trade and on the authorities' intention of reducing reliance on those taxes in the medium term, and give us some information about the results of the post-budgetary measures? On the expenditure side, given the size of the fiscal slippages connected with past program targets, it would seem that priority should be given to a consistent medium-term plan for reducing fiscal expenditures and rationalizing and restructuring government-owned enterprises. The elimination of sanctions on investments at both the federal and provincial levels, and the privatization of two of the nationalized commercial banks are welcome developments; however, these measures could be supported by conducting a careful review of the Central Government's spending programs and those of government-owned enterprises with a view to planning selective cuts and giving emphasis to the privatization process. Obviously, the reinforcement of the economy's cyclical tendencies that stem from the investment expenditures of the state enterprises causes large and inefficient resource misallocations. I would like to learn from the staff whether the current program for 1991/92 includes any incentives to the government-owned enterprises and, if such exist, to know their specific purposes. As to the measures taken to broaden the revenue base, I note that these depend wholly on the efficiency of the tax system, so while I urge the authorities to continue with their privatization program, that program should aim mainly at long-term growth and efficiency gains rather than at generating resources to finance budgetary expenditures. In this connection, the Government's intention of using the gains of privatization goes in the right direction.

International sympathy with the victims of the Middle East crisis and the lower than expected level of aid disbursements, combined with Pakistan's credibility, resulted in public and private entities successfully obtaining substantial amounts of short-term credit during 1990. Since a considerable share of these short-term credits fell due this year, it was necessary to roll over these obligations in a very unfavorable financial market climate, but this was not a problem. At the same time, the effect of the structural reform measures implemented the previous year, together with the effects of various export promotion policies, produced very strong export growth in 1990/91. The major aim in this area was to promote exports, in keeping with the plan for long-term improvement of the viability of Pakistan's balance of payments. But given the present hostile climate for further improving exports, especially of cotton-based manufactures, which account for more than half of total exports, it seems to me that the high rate of export growth projected for 1991/92 will be very difficult to achieve. Would the staff care to comment on this issue?

On the financing of the fiscal deficit, the discontinuation of major debt instruments and the delays in introducing auction markets for government securities have combined with the structure of maturities to require continuing reliance on debt rollovers. The high, ex-post real interest rate on long-term nominal bonds has made short-term borrowing appear particularly attractive. There is reason to be concerned about the possible costs of slippages in achieving the inflation reduction target. Surmounting the transitional obstacles to the establishment of auctions in the securities market will be an important step in this direction. It will provide a market-pricing mechanism for a highly standardized, risk-free instrument. The efficiency of the system can be further increased by offering a range of maturities to suit investor preferences. Does the staff have any information about the maturity structure of Pakistan's domestic borrowing?

With these remarks, I support the proposed decisions and wish the authorities every success in their efforts.

The staff representative from the Middle Eastern Department said that Chart 1 (EBS/91/191) served to illustrate the targets of the new program as compared with the targets in the second annual program. Equivalent targets had not been set in the new program, for two reasons. In the case of the policy instruments--the fiscal position and the rate of monetary expansion--the essential objective of the new program was to try to get back to the program path that had been set for the current fiscal year in the second annual program. For example, the fiscal position was in the range of 4.8 percent of GDP for 1991/92, as had been intended. The projected rate of real output growth for 1991/92 was now somewhat higher than previously expected under the program for the second annual arrangement, but that was because the actual growth rate in the previous fiscal year had been 6 1/2 percent, substantially above the targeted growth rate of 5 1/2 percent, as shown in Chart 1. The degree of monetary restraint in the new program was probably slightly greater in the new program than it had been in the program under the second annual arrangement.

As for the target variables--the current account, the inflation rate, and the stock of gross reserves--the desired outcome was in effect being postponed for one year, because at the time of the program under the second annual arrangement the problems that occurred in 1990/91, many of which were exogenous, had not been anticipated, the staff representative confirmed. In sum, in terms of the policy variables, the intention broadly was to bring the adjustment program back on track, although the outcome was postponed by one year.

As to whether the target for capital adequacy ratio of 3 percent of callable liabilities was ambitious enough, and whether an asset-side ratio weighted by the quality of assets might not be more appropriate, the staff representative observed that the financial position of both the nationalized commercial banks and many nonbank financial institutions in Pakistan was certainly very weak. The staff agreed strongly that the weak supervision and other problems of the past needed to be remedied. On the side of the banks, the 3 percent capital asset ratio had been discussed extensively between the World Bank and the authorities in the context of the Financial Sector Adjustment Loan. There had been much discussion about whether it was necessary to achieve the 3 percent ratio of callable liabilities before privatizing the banks, or whether some banks could be sold off before it was achieved. In fact, two banks had been sold, which raised the issue of exactly how to handle other nationalized commercial banks--whether to recapitalize them first through budgetary transfers or to sell them off.

As to the nonbank financial institutions, the serious problems were well known, the staff representative added. The Banking Companies Ordinance had been amended with the 1990/91 budget. The authorities had set up a department in the State Bank of Pakistan to supervise the nonbank financial institutions that would be operational on January 1, 1992. The staff had just received the new guidelines and reporting requirements for nonbank financial institutions. The situation should thus improve.

The growth of exports had been on the order of 23 percent on a customs basis in 1990/91, the staff representative noted, and the assumption for the medium term was that after declining to approximately 18 percent in 1991/92, export growth would taper off to approximately 6 percent in the medium term. The experience of recent years suggested that it was reasonably conservative to assume that a period of buoyant export growth would be followed by a slowing down. The export of cotton textiles, relative to raw cotton and cotton yarn, had certainly been fostered by the types of tax incentives mentioned in the staff paper. By and large, Pakistan had a comparative advantage in cotton textiles, and the incentives to increase the production of higher value-added textile for export, relative to raw cotton should result in the diversification of the export base that was needed to maintain high export growth.

The new Government had taken bold measures in the area of privatization, the staff representative from the Middle Eastern Department noted, with over 100 public sector corporations having been put up for privatization. Bids had been received for a large number, as mentioned by Mr. Mohammed, and thus far 20 had been accepted. Many of the corporations being sold were fairly small, and the proceeds received so far amounted to only Prs 200-300 million. But the authorities were trying to move aggressively, for the first time in many years.

The authorities' performance in reducing nontariff barriers had been quite good, the staff representative from the Middle Eastern Department stated. The negative list, which had been very extensive in 1988 when the program started, had now been reduced essentially to items that could not be imported for reasons of religion, security, and, in the case of textiles for instance, international agreements. Slower progress had been made in reducing tariff barriers and other taxes on international trade, and although more rapid progress would be desirable, it would depend on improved performance in domestic resource mobilization.

Mr. Filosa commented that he agreed with the staff that, given higher real GDP growth than previously envisaged, monetary restraint was stronger than in the previous fiscal year. His point was whether it might not be better to sacrifice some growth in the present, in exchange for a more sustainable rate of growth in the future. The current account deficit and gross official reserve accumulation remained particular weaknesses, and he would prefer to target slower GDP growth in exchange for a more rapid increase of official reserves and a better current account position.

The staff representative from the Exchange and Trade Relations Department explained that under Paragraph 60 of the decision on the compensatory and contingency financing facility, purchases relating to an excess in the cost of oil imports could be made after December 31, 1991 if the request had been initiated before that date.

Mr. Mohammed thanked Directors for the support for Pakistan's program. He would pass on to his authorities all the comments made. He did not think that there would be much, if any, divergence between the views expressed in the Board and his authorities' intentions in three areas: the introduction of a market-oriented monetary control system, closer monitoring of the fiscal position, and the strengthening of banking supervision.

On agricultural taxation, the problem, as pointed out by the staff, was an important constitutional one, Mr. Mohammed continued. It had to be recognized that the landed elite--perhaps the most powerful elite in the country--had far greater influence at the provincial than at the federal level. Therefore, changing taxation in the provincial sphere would be much more difficult than if the Federal Government had jurisdiction in the area. What the Federal Government had done by way of a second- or third-best solution was to impose export taxes on important cash crops, thereby mobilizing a portion of agricultural income to push up federal revenues. While that approach was seen as reliance on international trade taxes, it was in effect a way of taxing agricultural income. Indeed, the agricultural lobby pointed to export taxes as an example of how the agricultural sector was being made to pay income taxes.

The real issue in agricultural taxation was interpersonal rather than intersectoral equity, Mr. Mohammed added. In principle, interpersonal equity should be sought by taxing agricultural incomes directly. The principle of interpersonal equity could not be applied even to nonagricultural incomes if any part of the latter could be attributed to agricultural activities. All that had been possible to accomplish in that respect was to try to make some estimation of income from the agricultural sector in order to determine the marginal rate of tax on nonagricultural income. That practice was known as "clubbing" and it did lead the tax authorities to ask questions about income attributed to agricultural activities. He would be loath to say that taxing agricultural income directly would become politically feasible in the near future. His own hope was that with the provinces being given greater incentives to hold on to the taxes that they raised to use for development purposes, they would gradually begin to move in that direction. However, progress would more likely come by way of a land tax rather than through a direct tax on agricultural incomes. In the meantime, given that the agricultural sector was a large proportion of GDP, the share of direct taxation would remain fairly low; it was approximately 2 1/2 percent in 1990/91, and the hope was to increase it by about 1/4 percent of GDP for each of the next two years, which was a fairly large effort on a rather low base.

As for the degree of monetary restraint, the authorities were beginning to feel that the monetary policy in place was perhaps excessively restrictive, Mr. Mohammed noted. For the first time in Pakistan's history, real estate was falling in price, not only urban property but agricultural land as well. Thus, while there was still inflation in reproducible goods and services, there was a whiff of deflation in the air as far as asset values were concerned, and the outlook in the years ahead was hard to predict. The Government believed that the financial sector reforms were partly responsible because of the better incentives to invest in financial assets rather than in land.

The Government had been single-minded in its pursuit of privatization, Mr. Mohammed continued. A great deal of caution had been expressed as to whether the capital markets were large enough to take on the number of enterprises being put up for sale. In fact, only 27 bids had been accepted to date in cases where bids came in above the reference prices. His own feeling was that the process would be much slower than initially intended, particularly in the case of the financial institutions. The higher the price exacted from the buyer of a financial institution, the greater the possibility of a risk being placed on that institution, if the buyer wished to recoup the capital investment quickly. That explained the debate on whether to recapitalize first or to sell at a lower price; after the first two bank privatizations, the authorities had decided to give the matter further thought.

On the subject of public expenditures--and particularly high defense expenditures--Pakistan was in a region where tensions were growing, Mr. Mohammed noted, especially to the north, with the dissolution of the Soviet Union. Without any doubt, the authorities would like defense expenditures to be lower, but only in the context of a regional resolution of problems that had hung fire for a very long time.

The question had been raised, Mr. Mohammed noted, of why the objectives of the program were not being targeted in line with the original intentions in 1988/89. There had been two developments since that time. First of all, the original staff program had proceeded on the assumption of fairly stable terms of trade, which in the event had declined by 10 percent in 1988/89. In 1990/91, there had been another 13 percent deterioration in the terms of trade. Given that kind of external squeeze on the economy, it was difficult to go back to the original targets.

Second, there had been a great deal of political change in the country since the program was first developed, Mr. Mohammed recalled. The Government currently in office was the fourth to implement a program that was agreed to in 1988. Although on the whole, there was a clear agreement on objectives across the political spectrum, momentum had been lost at critical moments because of political changes. Political developments worked with their own time lags, and he would therefore be very surprised if the original targets of 1988/89 could be resurrected. Developments were moving in the right direction, and the new Government, in particular, had been very eager to make the right moves, both on structural and on macroeconomic reform. He hoped that that attitude would provide the basis for a continuation of Fund support under an enhanced structural adjustment arrangement, at the earliest feasible date. It was of some concern to his authorities that, as the eligibility list for the ESAF was enlarged, with no corresponding increase in the availability of funds, demands for programs supported by the ESAF would crowd out countries like Pakistan. And his authorities did remain interested in a program to be supported under an enhanced structural adjustment arrangement.

The Executive Board then approved the following decisions:

Exchange System

Pakistan maintains a number of restrictions on the making of payments and transfers for current international transactions in accordance with the transitional arrangements of Article XIV, except for the restrictions evidenced by a bilateral payments arrangement with a Fund member and the payment of an import license fee required at the time of opening the letter of credit or of payment for imports, which also gives rise to a multiple currency practice. These measures are subject to Fund approval under Article VIII, Sections 2 and 3. The Fund welcomes the recent action of the authorities to eliminate certain restrictions on invisible payments and their intention to eliminate in 1992 the restriction evidenced by the payment of the fee required at the time of opening the letter of credit or of payment for imports. The Fund grants approval for the retention of the exchange restriction and multiple currency practice arising from the imposition of this fee until July 1, 1992 or the date of completion of the 1992 Article IV consultation with Pakistan, whichever is earlier. The Fund urges the authorities to phase out remaining restrictions, in particular the restrictive features of the remaining bilateral payments arrangement with a Fund member, as soon as possible.

Decision No. 9876-(91/168), adopted
December 16, 1991

Structural Adjustment Facility - Third Annual Arrangement

1. The Government of Pakistan has requested the third annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Pakistan in implementing the policies and reaching the objectives of the program supported by the second annual arrangement, and notes the revised and updated policy framework paper contained in EBD/91/307.

3. The Fund approves the arrangement set forth in EBS/91/191, Supplement 2.

Decision No. 9877-(91/168), adopted
December 16, 1991

Purchase Transaction - Compensatory and Contingency
Financing Facility - Fluctuations in Cost of Oil Imports

1. The Fund has received a request by the Government of Pakistan for a purchase equivalent to SDR 122.4 million for compensation of an excess in the cost of Pakistan's oil imports under Section V of the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended).

2. The Fund approves the purchase in accordance with the request.

Decision No. 9878-(91/168), adopted
December 16, 1991

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/167 (12/11/91) and EBM/91/168 (12/16/91).

3. COTE D'IVOIRE - STAND-BY ARRANGEMENT - FINANCING

The Fund decides that the first review on the financing of the program contemplated in paragraph 4(c) of the stand-by arrangement is completed. (EBS/91/207, 12/5/91; and Cor. 1, 12/6/91)

Decision No. 9879-(91/168), adopted
December 11, 1991

4. AUDIT COMMITTEE, FY 1992 - COMPOSITION AND NOMINATIONS

The Executive Board approves the Managing Director's recommendation that France, Bolivia, and Mauritius be invited to submit nominations of persons to serve on the External Audit Committee for financial year 1992 and confirms the nominations set forth in EBAP/91/285 (12/4/91).

Adopted December 13, 1991

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/91/294 (12/10/91) is approved.

APPROVED: June 18, 1992

LEO VAN HOUTVEN
Secretary