0404

NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/168

10:00 a.m., December 22, 1989

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	G. C. Noonan
	Zhang Z.
	A. Rieffel, Temporary
	H. S. Binay, Temporary
	L. B. Monyake
E. A. Evans	S.-W. Kwon
	P. O. Montórfano, Temporary
	R. Marino, Temporary
	A. Fanna, Temporary
M. Finaish	A. M. Othman
	A. Gronn, Temporary
M. R. Ghasimi	
	H.-J. Scheid, Temporary
J. E. Ismael	
	A. Raza, Temporary
	G. Bindley-Taylor, Temporary
	J.-F. Cirelli
	J. K. Orleans-Lindsay, Temporary
	Z. Iqbal, Temporary
	G. P. J. Hogeweg
K. Yamazaki	

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

Also Present

IBRD: L. Yap, Europe, Middle East and North Africa Regional Office. Asian Department: M. W. Bell, J. S. Kahkonen, S. M. Schadler. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; B. Christensen, S. Kanesa-Thasan, M. Shadman-Valavi. External Relations Department: A. F. Mohammed, Director; S. Nawaz. Legal Department: J. K. Oh. Middle Eastern Department: A. S. Shaalan, Director; P. Chabrier, Deputy Director; D. G. Demekas, F. Drees, S. H. Hitti, M. D. Knight, E. B. Maciejewski. Research Department: N. U. Haque, M. S. Khan. Secretary's Department: A. Tahari. Advisors to Executive Directors: M. A. Ahmed, F. E. R. Alfiler, M. B. Chatah, J. M. Jones, K.-H. Kleine, J.-L. Menda, B. S. Newman. Assistants to Executive Directors: S. K. Fayyad, J. Gold, L. Hubloue, K. Ichikawa, M. E. F. Jones, G. Montiel, N. Morshed, S. Rouai, J. G. Westerweel.

1. PAKISTAN - 1989 ARTICLE IV CONSULTATION; REVIEW UNDER STAND-BY ARRANGEMENT; AND STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1989 Article IV consultation with Pakistan, Pakistan's request for a second annual arrangement under the structural adjustment facility, and the review under the 15-month stand-by arrangement for Pakistan approved on December 28, 1988, together with a requested modification of that arrangement (EBS/89/228, 12/1/89; and Cor. 1, 12/15/89). They also had before them a policy framework paper for Pakistan for 1989/90 through 1991/92 and a background paper on recent economic developments in Pakistan (SM/89/264, 12/11/89).

The Deputy Managing Director made the following statement:

There follows for the information of the Executive Directors the text of a memorandum that I have received from the President of 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 18, 1989.

The Committee of the Whole reviewed the second-year policy framework paper for Pakistan on December 14, 1989. The Directors noted with approval the Government's commitment to adjustment and commended the Government for progress already made in adopting the structural reforms laid out in the policy framework paper, including trade liberalization. These steps should strengthen economic competitiveness and encourage private economic activity, including direct foreign investment. However, they expressed concern about the slippages in the fiscal area and, in particular, about the large external current account deficit in FY 1989 and low external reserves.

Directors noted that the Government's ability to adjust the external current account more rapidly had been affected by the deterioration in the terms of trade. They emphasized the need for both structural reforms and active demand management to reach the current account deficit target by FY 1992, one year behind the original schedule. In the past fiscal year, it was noted, the Government had responded to the terms of trade difficulties by depreciating the real exchange rate further and tightening monetary policy. These measures, together with the Government's trade policy reforms, should result in a broadening of the export base.

Directors stressed the importance of strengthening the fiscal situation and increasing revenues. Although the revenue/GDP ratio was expected to fall temporarily in FY 1990, it was noted that the Government was making progress in resource mobilization, and had in fact intensified the structural reform of the tax system in FY 1990. Besides expanding the coverage of the existing sales tax and extending excise taxes to services, it had also broadened the income and profit tax base and raised administered prices. It was also on schedule in preparing for the introduction of a generalized sales tax in July of next year. In addition, it had converted a large number of specific customs duty rates to ad valorem rates. While noting the steps already taken, Executive Directors emphasized the importance of enhanced determined action to reduce the fiscal deficit and strengthen the revenue base.

In view of Pakistan's need for infrastructure and social investments, the reduction in the Government's investment/GDP ratio in FY 1989 was disappointing. Executive Directors pointed to the need to prioritize investments and noted, in particular, the need for special programs in the social sectors, given Pakistan's relatively poor social indicators.

Several speakers expressed concern about the social impact of the program. It was noted that, in the past fiscal year, the Government had taken steps to shield the lower income population from the full burden of adjustment. Increases in electricity and natural gas prices were lower for the smallest consumers, and the Government did not pass on the full cost of wheat and edible oil imports to the population. Having an additional year to reach the macroeconomic targets was acknowledged as helpful to the Government in minimizing the cost of adjustment. Directors also drew attention to the importance of drawing up a comprehensive environmental program and noted with approval that steps to this end had already been taken.

Directors commented on the Government's progress in privatization and improving the efficiency of parastatals. Note was made of the progress in private sector power generation and in the financial area, where the Government had sanctioned six private investment finance companies and was actively exploring ways to privatize part of the nationalized banking system. Steps were also being taken to restructure some of the other important public sector companies.

Finally, Directors stressed the need to consolidate and extend reforms, despite the Government's continuing political and economic difficulties. Several Directors referred to Pakistan's need for external assistance and to the substantial support that was being provided by the donor community to Pakistan. Directors confirmed that in view of the heavy burden of indebtedness, and the impact of worsening terms of trade, Pakistan will continue to need substantial external assistance in support of its adjustment program.

Mr. Finaish made the following statement:

In 1988-89, the Pakistan authorities, after close consultations with the staffs of the Fund and the Bank, embarked upon a comprehensive medium-term program of economic and structural reforms aimed at restoring stability in domestic demand management and a viable external position. In support of the Government's program, which was finalized with the 1988-89 budget, the Fund's Executive Board approved in December 1988 a three-year arrangement under the structural adjustment facility and a 15-month stand-by arrangement.

The objective of the authorities' medium-term program is to implement vigorous fiscal and monetary policy adjustment, supplemented by appropriate structural and external sector reforms with a view to restoring fiscal and balance of payments viability while maintaining the strong economic growth performance of recent years. To achieve these objectives, the program embodies a comprehensive set of structural policy actions including major initiatives for reducing the overall fiscal deficit, further trade liberalization, continued progress in reducing cost-price distortions, and improved incentives for private sector capital formation. These measures are to be complemented by a restrained domestic financial stance, reforms in the agricultural, energy and financial sectors which are supported by sector loans from the World Bank, as well as continuation of flexible exchange rate management.

The record of implementation under the program shows that success has been achieved in attaining most of the financial and structural reform objectives. A number of important adjustment and structural reform measures were implemented in all major program areas during 1988-89. Structural benchmarks were observed in most areas and all quantitative performance criteria and quantitative benchmarks were adhered to except for that on net international reserves in June 1989. My authorities believe that this is a good record of program implementation when viewed against the background of the profound political changes that took place in 1988-89, as well as adverse external economic developments. After a turbulent interregnum of over a decade, free general elections were finally held in November 1988 and a new Government was installed. Excessive rains and floods in August-September 1988 caused damage to crops and industrial units thereby affecting output and exports. Furthermore, Pakistan experienced a sharp and unexpected worsening in the external terms of trade, which substantially curtailed export earnings despite good volume growth. Finally, the existence of a growing number of Afghan refugees in Pakistan, presently estimated by the World Bank to have touched the 3.8 million mark, has placed increasing stress on the task of economic management. The authorities' record of implementation of structural economic reforms in 1988-89 should be judged against these special circumstances and the fact that the new Government had been in power for only some six months by the close of the fiscal year.

Economic developments and policies in the first year of the program as well as the outlook for the medium term are set out in comprehensive detail in the staff documents and the authorities' policy framework paper. In my statement, therefore, I intend to draw attention to some of the salient features of the economic situation and the authorities' record of program implementation.

In 1988-89, despite the severity of the floods and civil disturbances in major industrial cities, real GDP rose by over 5 percent, somewhat in excess of the program target. Performance in the agriculture sector was good with significant output gains having been recorded in the case of wheat, rice, and sugarcane; raw cotton production was close to the record level reached in 1987-88. Overall, real value added in the agriculture sector increased by more than 6 percent in 1988-89. After growing by close to 8 percent per annum in real terms in the recent past, the pace of expansion in the large-scale manufacturing sector slowed sharply in 1988-89 reflecting a number of diverse, but largely special, factors including a temporary fall in capacity utilization rates in some industries due to the floods and civil disturbances.

Developments in the other sectors, however, were more favorable. Growth in the electricity and gas subsectors was estimated at 7 percent. Domestic oil production rose by 10 percent and covered about 35 percent of Pakistan's needs. The coming on stream of two additional power stations helped ensure a better balance between power supply and demand. Gas production rose by 4 percent while growth in the remaining sectors is estimated at 6 percent.

Investment performance was encouraging. While the reduction in the size of the public sector development program due to the dictates of fiscal prudence led to some shortfalls in planned expenditures, there were indications that private investment was responding strongly to the changed policy environment. A new industrial policy was introduced. Its principal features are a further reduction in the list of industries requiring government permission and liberalization of sanctioning procedures including setting a 60-day time limit for approval of a project. More importantly, a Board of Investment has been set up with the Prime Minister as its head to monitor the pace of industrialization and lay down policy guidelines. According to recent information, sanctions for new investments by the Board have touched a record.

In the area of fiscal reform, which is the cornerstone of the authorities' adjustment program, a number of concrete steps were taken designed to broaden the domestic tax base and make the tax system more equitable thereby increasing significantly its yield and elasticity. The details of the various measures are described in the staff report. Total tax revenues were on target (rising by close to 18 percent over year-earlier levels), while total government fiscal revenues--which include the surplus of autonomous bodies--increased by over 17 percent and reached the programmed level of 18.8 percent of GDP. However, current expenditures exceeded the target by a modest margin due primarily to larger than projected subsidy outlays reflecting substantial wheat imports at higher than anticipated world prices and larger demand stemming from acute food shortages in Afghanistan. In order to stem the rise in subsidy payments, the authorities increased the issue price of wheat, a basic wage good, by significantly more than originally programmed. As a result of these revenue and expenditure developments, the overall fiscal deficit was reduced by 1.5 percentage points to 7.1 percent of GDP.

The growth of domestic credit was firmly restrained in 1988-89 and was well within the program limits. This reflected the authorities' determination to dampen price pressures following the flare-up of inflation at the end of 1987-88 and at the beginning of 1988-89 owing to the spillover of excess demand pressures from the previous year, the uncertainty and disruptions during the first part of 1988-89, and flood-related food price increases. The authorities also took a number of steps to reform the financial sector.

An important instrument in the authorities' adjustment program in the real sector was the renewed emphasis on trade policy reforms supported by implementation of a flexible exchange rate. The actions taken in 1988-89 constituted a significant phase in the authorities' efforts to establish a more liberal trade regime.

Developments in the external sector, however, were less favorable owing principally to an unexpectedly sharp deterioration in Pakistan's external terms of trade. As a consequence, the program's external sector objectives set for 1988-89 were not met. Although export volume growth at 11 percent was somewhat above the program target--and well above the trend growth in exports in the last few years--and new records were set for exports of raw cotton and cotton yarn, the total dollar value of exports increased by only about 5 percent as a result of a steep fall in world prices for Pakistan's key exports. While overall import volume growth was modest owing to the restrained credit and demand management stance referred to above--and was reinforced by flexible adjustments in the exchange rate with the rupee depreciating by more than 9 percent in real effective terms by end-November 1989--and external workers' remittances increased significantly in the latter part of the year, the external current account deficit exceeded the program target by almost $600 million.

In addition to the demand and exchange rate management measures taken in response to the deterioration of the external current account, the authorities mobilized additional quick-disbursing balance of payments assistance and accelerated the pace of disbursements from committed aid. As a consequence, gross aid disbursements were some $400 million above program projections and the overall balance of payments deficit was contained to $150 million. While this was a considerable accomplishment, it represented a marked deviation from the targeted surplus of $99 million. Given the severity of the terms of trade shock and the consequent abrupt widening of the external deficit, and notwithstanding the sharp increase in disbursements of external assistance and purchases under the Fund arrangements, the programmed increase in gross official reserves did not materialize.

The authorities are of the view that the macroeconomic adjustment and structural reform measures that were implemented during 1988-89 have made a significant contribution to redressing past imbalances. These measures have stabilized economic and financial conditions and have brought about a welcome restoration of business confidence as reflected in the behavior of private investment sanctions and external workers' remittances. Despite these accomplishments, however, they recognize that further stabilization measures are needed to place the economy firmly on a path of sustainable growth with acceptable levels of price inflation. While the authorities remain committed to persevering with their reform agenda, they are of the view that given the very substantial deviation from program targets which occurred on the balance of payments in 1988-89, and the likely persistence of adverse external price developments in the immediate term, more time will be required to bring about needed adjustment on the external account. They have therefore proposed to achieve the major macroeconomic objectives of their original program, including the targeted reduction in the overall fiscal deficit, one year later than originally programmed, that is, by 1992. The staff considers this proposed modification in the initially envisaged time frame as being appropriate.

The staff has taken the view that the authorities should have implemented a large increase in petroleum prices which would have served to enhance petroleum surcharge receipts and accelerated the process of fiscal deficit reduction. My authorities are of the view that such an increase, coming on top of the other tax and nontax revenue raising measures, would have been counterproductive. Given that the authorities were confronted with strong inflationary pressures in 1988-89, an increase in petroleum prices of the magnitude proposed by the staff would, they believe, have merely aggravated the inflationary situation and, possibly, jeopardized the smooth implementation of other important reform measures. However, my authorities wish to affirm that the deferment of the petroleum price increase does not in any way reflect a weakening in their resolve to persevere with their adjustment efforts or take difficult decisions.

The main objectives of the authorities' macroeconomic and adjustment program in 1989-90, as reflected in the budget for the present fiscal year and as set out in the authorities' memorandum of economic policies, is to undertake further fiscal adjustments through enhanced revenue measures and strict expenditure restraint. The 1989-90 budget measures entailed a further extension of the sales tax, the introduction of new excise duties on some services and an enhancement in tariff revenues. Nontax revenues will also be bolstered by the increase in telephone charges and a significant increase in electricity tariffs.

Current expenditures in 1989-90 are to be tightly restrained and are projected to fall as a percent of GDP so as to permit some growth in development expenditures to meet the new Government's economic and social objectives and improve income distribution. Despite the limits on development expenditures necessitated by macroeconomic constraints, the authorities have made efforts to protect essential social programs, particularly for primary and female education, health, rural water and urban improvement, and core investment programs in energy, agriculture, transport and communications. The World Bank and Asian Development Bank's lending programs are directed at supporting these important social and infrastructural investments.

Structural economic reforms across a number of sectors and flexible pricing policies are to continue as planned. The new Government's privatization program is expected to gain momentum with the first sale of shares expected by the end of the fiscal year. Economic growth is projected to accelerate over the next two years on the strength of growth in agriculture and the revival of the manufacturing sector while inflation is expected to decline to more acceptable levels. The external program objectives are to achieve a reduction in the current account deficit and a concurrent buildup of foreign exchange reserves to more adequate levels through exchange rate management and a better set of export incentives aimed at stimulating nontraditional exports. Despite this projected improvement in the external account, Pakistan will continue to need external donor support, including quick-disbursing balance of payments assistance, to facilitate the implementation of structural reforms and a buildup of reserves during the program period and thereafter. Trade liberalization will remain a key element of the program aimed at achieving a more open trading system fostering competitive industries. However, the authorities remain concerned that increasing protectionist measures, which at present apply to almost 60 percent of Pakistan's exports, could inhibit export growth making it more difficult to continue to liberalize imports.

Overall, I believe that Pakistan's record of implementation in 1988-89 has been broadly in line with the stipulations of the program. The breadth of the authorities' reform effort has been impressive. Important policy reforms, with a significant structural content, were put in place, and in a number of important areas the program targets were met and in some cases the targets were exceeded. The pace and content of reform measures were appropriate, and the authorities demonstrated their determination to adhere to the objectives of the program by taking measures which required political courage in difficult internal and external circumstances and against a backdrop of an uncomfortably high level of inflation. These measures were not easy especially for a government which had just come to power on the strength of its commitment to undertake extensive socio-economic reforms.

The authorities' determination to adhere to the program objectives can be judged by the fact that the total impact of the various measures taken to reduce the fiscal deficit during the last one year is about Rs 18 billion, or 2 percent of GDP. This includes prebudget and postbudget pricing measures in respect of wheat, power tariffs, gas, and fertilizer yielding additional resources of Rs 5.6 billion; reductions in current expenditures amounting to Rs 2.7 billion; taxation measures with the budget amounting to Rs 6.7 billion; and nontax measures of Rs 2.6 billion.

Inevitably, however, given the breadth and complexity of the program, there were some slippages, notably in meeting the balance of payments objectives and, to a smaller extent, on the budget. In the former case, as the authorities have indicated--and as has also been brought out in the staff report--this outcome was unexpected and therefore entirely beyond the authorities' control. The reaction of the authorities to the external shock was prompt and firm. They reinforced fiscal discipline with restrained credit policies and further exchange rate adjustments while protecting the economy's growth potential. On the budget, the slippage was relatively modest and was also due largely to special factors. What needs to be underscored is the fact that strong fiscal measures were indeed taken and that a decisive and bold move was made to reverse past imbalances by implementing important and lasting structural reforms across a broad front.

For 1989-90 and beyond, the authorities intend to continue to take actions that will further strengthen the structural aspects of their adjustment program. While a promising start has been made, the Pakistan authorities recognize that further stabilization efforts are needed to improve the fiscal position and external account, reduce inflation, and raise savings and investment. The additional measures that have been introduced with the budget of 1989-90 and those contemplated over the following two years provide strong evidence of the authorities' continuing commitment to the reform program. These measures will help establish a macroeconomic and financial environment conducive to self-sustaining growth. My authorities have also given an assurance that although the measures set forth in their policy framework paper are adequate to meeting the objectives of their program, they will take further contingency measures, as appropriate, to ensure that the program is firmly adhered to and remains on track.

Continuing, Mr. Finaish said that information he had just received from his authorities showed that, in general, economic developments in 1989-90 continued to be favorable and the program remained on track. Revenue collection and expenditure levels up to November 1989 were somewhat better than had been expected. On the revenue side, 43 percent of the annual target had been met with revenues from sales and customs duties ahead of the target. Indeed, the growth in revenues from the sales tax had been especially buoyant and provided a solid base for the transition to the general sales tax scheduled for implementation in 1991. Expenditure levels were lower than at the same time one year earlier, and bank borrowing for the budget as of December 7 was one fourth the ceiling fixed for end-December. Excluding primary commodities, where special factors (including low beginning year stocks) distorted the picture, exports had risen by 21 percent in dollar terms in the first five months of 1989-90, despite the continued persistence of weak prices. External workers' remittances had risen by some 16 percent in the same period. By end-November, the Pakistan rupee had depreciated by more than 9 percent in real effective terms compared to the index in April-June 1988, which had enabled the authorities to meet the relevant performance criteria for December 1989. Inflationary pressures continued to abate, with inflation currently running at about 6 percent, a rate that was below the program target. The manufacturing sector was showing distinct signs of revival, as reflected in the good export figures he had mentioned. Finally, the present indications were that the cotton crop would reach 9 million bales, a new record.

Mr. Iqbal made the following statement:

Significant progress has been made toward the implementation of the medium-term adjustment program in Pakistan. As is indicated in the voluminous staff report and Mr. Finaish's opening statement, important structural reforms have been implemented on schedule, including trade liberalization and tariff rationalization, strengthened financial sector supervision and regulation, streamlined regulation of the industrial sector and investment, and a revamped tax system. At the same time, an appropriately flexible exchange rate policy has been pursued, and a number of administered prices have been adjusted, including interest rates, in order to reduce subsidies and improve resource allocation. Consequently, the economy has continued to grow briskly, and inflationary pressures have moderated, as credit expansion has been kept well below the programmed level. In particular, private sector investment is responding strongly to the changed policy environment, which augurs well for the future. It is heartening to learn from Mr. Finaish's statement that the program for 1989/90 is being implemented as envisaged, and that exports have grown strongly in 1989.

However, progress toward correcting the fiscal imbalance has been slower than planned. At the same time, despite tight demand-management and appropriate exchange rate policies, recovery of the external sector has been frustrated by a large deterioration in the terms of trade. In view of the poor prospects for the terms of trade, the external outlook for the medium term looks somewhat somber. Under these circumstances, the authorities will need to pursue a delicately balanced and socially acceptable pace of adjustment. Therefore, I support the authorities' plan to stretch the period of adjustment by one year. I am happy to note that the authorities are cognizant of the need to make up for slippages in the previous year. Given the Government's determination as demonstrated in the implementation of politically difficult economic changes since it assumed office at the end of 1988, I have no doubt that the authorities will be able to take the needed additional steps.

It is crucial that there should be no let up in expanding national savings, so that the much-needed shift from consumption-induced growth toward investment-driven expansion can be sustained. This will be a time-consuming process. At the heart of such a strategy, as rightly identified by the staff, are policies to strengthen public sector finances and structural measures to foster public sector savings, encourage domestic and foreign direct investment, and diversify and promote exports.

Regarding the fiscal effort, I fully support a timely introduction of the general sales tax, a speeding up of income tax reforms, an upward adjustment in administered prices, and a redirection of spending toward human and physical capital formation. However, I would be concerned about increases in petroleum product prices significantly above the relevant world market prices. As this chair has emphasized on various occasions, these prices also enter the cost side of the equation, and it would be highly undesirable to see the competitiveness of certain critical economic sectors artificially sacrificed by high oil product prices. The staff should always try to balance the benefits of increased revenue against the costs of lost competition. It should be noted that, in Pakistan, such prices are higher than the relevant world market prices for petroleum products. It is also interesting to note that such prices have either been adjusted upward or have remained unchanged during the past four-year period in which world oil prices fell by about 45 percent.

I am inclined to agree with the authorities' preference to follow a more systemic approach to raising revenues rather than to seek an easy way out through raising oil product prices. This, however, does not mean that decisive action on the revenue front can be delayed. A better approach would be to tap other sources of revenue and further contain current expenditures. Clearly, the agricultural sector remains undertaxed, owing in part to social and political considerations. It seems that even a modest adjustment in land valuation toward market prices would generate a surge in revenues. I would appreciate staff comments on the authorities' plans to extend agricultural taxation. I would also like to know about the progress made so far in implementing the general sales tax.

An area of particular significance for future growth is the pace and content of the privatization process. Mr. Finaish's statement indicates that this program is expected to gain momentum in the current fiscal year. Can the staff provide more information on the time frame and mode of this program? Is the capital market adequately developed to handle a sizable sale of public sector assets? What role is the World Bank group playing in facilitating the privatization process? What more can the Fund do to assist the authorities? The staff rightly alludes to the need to mobilize savings through the banking system. It seems that this process would be greatly facilitated by the privatization of the banking sector itself. What steps have been taken to either privatize the nationalized banks or to allow the establishment of new private banking institutions? What additional steps would the staff recommend in this context?

I am pleased to note that the authorities have undertaken major steps toward eliminating the differential treatment of indigenous and foreign investors, and that the existing incentives framework has been further liberalized to promote foreign direct investment. Domestic private investment appears to have picked up significantly, and the staff contends that further steps are needed to encourage foreign direct investment. In particular, it suggests that limits on the proportion of foreign direct investment should be eliminated. Would this or similar steps be enough to unleash foreign direct investment, or would more need to be done to strengthen investor confidence?

As to the exchange and trade system, I agree with the staff assessment that, as in the past, the exchange rate policy should continue to be implemented flexibly. However, it is important that Pakistan's exports have freer access to world markets if the program objectives are to be realized.

It appears that Pakistan's external accounts will remain under pressure even beyond the current arrangement, and that the need for concessional assistance will continue. Pakistan has remained current in its debt-service payments and is successfully implementing a strong adjustment program in the upper credit tranches. In view of the medium-term outlook and its adjustment efforts so far, it would seem prudent to consider Pakistan for an arrangement under the enhanced structural adjustment facility upon the expiration of the current stand-by arrangement.

I support the proposed decisions.

Mr. Yamazaki made the following statement:

A year ago, the Executive Board welcomed Pakistan's comprehensive and very detailed adjustment program, and warmly endorsed the Fund's support of the country's adjustment efforts through the stand-by and structural adjustment arrangements.

Overall policy implementation by the authorities has been satisfactory and broadly in line with the first-year program. In particular, the authorities achieved important progress in trade liberalization and other structural reforms. However, the economic outcome in this period was mixed.

I welcome the fact that the authorities' stringent monetary stance has successfully contained the rate of price increase. On the other hand, a sharp decline in the terms of trade resulted in the widening of the current account deficit. It is regrettable that Pakistan failed to observe performance criteria on net international reserves and short-term external liabilities--owing to the increase in the external imbalance--given the small margin in Pakistan's foreign reserve position. While the reduction of the fiscal deficit is welcome, it fell short of the program target. While the growth rate turned out to be more favorable than programmed, I note in the staff report the decline in domestic savings and investment.

Pakistan is struggling with these difficulties and is now in a critical phase of adjustment. I would like to reiterate my view that the thrust and basic design of the adjustment program are supportable. However, in the face of the adverse developments in the economy, the authorities should not hesitate to strengthen the program with additional measures. In this connection, I wonder whether there was not room for taking complementary measures in order to achieve the fiscal target during the latter half of 1988/89.

I will now comment on specific policy issues. Improvement in the fiscal balance is an urgent objective, as is recognized in the policy memorandum. In this vein, the timely implementation of the tax reforms has significantly strengthened the tax structure. I also welcome the planned introduction of the general sales tax, although this reform may not generate much additional revenue in its first year. On the other hand, I share the staff's view that much could be done in the area of the income tax. I am interested to know the revenue-enhancing effect of the extension of the income tax to the agricultural sector. In addition, it might be necessary to review the remaining and newly granted income tax exemptions in the macroeconomic framework. I welcome the considerable progress achieved in the area of administered prices. While I understand the difficulty in raising petroleum prices, the fiscal impact of price control could be given more attention in the context of the examination of the appropriate level of administered prices.

On the expenditure side, I share the staff's concern about the increase in subsidy payments. The authorities should be encouraged to address this issue. I wonder whether there is not scope for sharing the burden of certain subsidies with local governments. That may necessitate fiscal reform in the local government finances. I would appreciate the staff's view on this issue. Overall, while I sympathize with the authorities, who face political constraints, I encourage them to continue vigorous efforts at fiscal restructuring. In this respect, I must hastily add that, after hearing Mr. Finaish's most encouraging statement, I feel more assured than before of the prospects for fiscal improvement.

On the monetary front, I welcome the authorities' stringent stance on credit and monetary policy, and I encourage the authorities' efforts to adhere to the original targets. In my view, the authorities could give more importance to the improvement of the efficiency of financial intermediates to encourage domestic savings. It can also be supported by accelerating the introduction of market-based controls.

In the external sector, I welcome the progress in trade liberalization. However, given the small margin in the foreign reserve position, close monitoring of the external balance and the exchange rate is warranted. To underpin the capital formation necessary for growth, Pakistan will continue to rely on foreign direct investments and concessional external supports. I agree with the staff that foreign direct investment could be encouraged by further eliminating discriminatory sanctions and liberalizing the exchange regime. I support the proposed decisions.

Mr. Binay made the following statement:

Before discussing the current situation and medium-term prospects of Pakistan's economy, I would like to stress some of Pakistan's unique features, as noted in the most recent background paper, to guide our discussion.

Pakistan's agricultural sector accounts for about one fourth of GDP at factor cost, employs over half of the labor force, and brings in about 60 percent of the country's export earnings. Foodgrain self-sufficiency was attained in 1985/86 and was maintained in 1986/87. It is estimated that at least 40 percent of the wholesale price index consists of commodities whose prices are either directly set by the Government or heavily influenced by government actions. The share of direct taxes in total revenue is very small. Income and profits tax rates have historically hovered around 10-11 percent. Pakistan's domestic monetary and credit policies rely on a system of global ceilings. Direct and selective controls are the primary instrument for regulating the growth of domestic credit and its distribution by the banking system. In the export sector, nontariff restrictions are estimated by the authorities to have covered nearly 60 percent of Pakistan's exports in 1988/89. The World Bank has estimated that there are about 3.8 million Afghan refugees in Pakistan, their number having increased about 70,000 since the beginning of 1989. To these facts I should add that Pakistan has achieved a phenomenal growth rate during the present decade with relatively moderate inflation, and the authorities' determination to service all external debt obligations on schedule is to be commended.

I will now comment on the issues under discussion. We are glad to note that all the quantitative performance criteria have been observed with the sole exception of a June 1989 dip in net international reserves. The results were less consistent for structural benchmarks, which were observed in all but two major areas: delays in the completion of a study of the rice and cotton exporting agencies caused postponement of the action program for improving their corporate efficiency, and implementation of the financial sector reform benchmarks for evaluating and improving the soundness of financial institutions did not occur as planned. Considering the comprehensiveness of the program, delays affecting only a few areas may seem tolerable, but should serve to dispel any complacency.

The 1989/91 program, and the medium-term continuation of the adjustment and reform efforts to liberalize the economy, are of the greatest importance. For the present, extension of the general sales tax to cover the services sector, which has a substantial share of GDP, will be the main step toward preparing the economy for rapid deregulation. We have observed in many cases how implementing a shock liberalization of pricing and marketing controls, in the absence of appropriate measures to improve the elasticity and coverage of the tax system, have led to less efficient resource allocation. Once the general sales tax changes have been implemented, the next step toward achievement of the fiscal targets will be improving the assessment and collection of direct taxes. The rapid accumulation of domestic public debt, from 25 percent of GDP in 1980/81 to 43 percent in 1988/89, signals the urgency of accelerating efforts to improve Pakistan's fiscal position. From a fiscal standpoint, the continued existence of subsidies to agriculture--whether operating at the producer level in the form of fertilizer subsidies, user charges insufficient to recover the cost of irrigation, and low loan collection rates, or at the marketing level in the form of wheat and soy oil subsidies--seems inconsistent with the present view of the agricultural sector as a potential source of tax revenues. I would be grateful if the staff could elaborate on these issues, including the likely effects of taxing the agricultural sector on its labor absorption capacity, and the potential social impact of abolishing the subsidies.

In the financial sector, the envisaged reforms aimed at better resource mobilization and enhancing national saving are most welcome. Introducing market forces into the financial sector, accelerating completion of legislation for improving auditing procedures, and identifying nonperforming loans are necessary steps in this process. We also regard the sanctioning of six private investment finance companies to operate in Pakistan as a clear indication of the Government's intention to induce competition in the financial sector.

The industrial sector, which in the past was subject to heavy-handed regulation and administrative obstacles, has responded in an encouraging manner to the changed policy environment, as is mentioned in Mr. Finaish's opening statement. In light of Pakistan's balance of payments needs, is the current regulatory climate sufficiently competitive to attract foreign direct investment? I would also be interested in the staff's views on this point.

In the areas of external sector and exchange rate policies, the authorities' response to the sharp deterioration in Pakistan's terms of trade is remarkable. The implementation of the flexible exchange rate policy to compensate for the terms of trade losses, and the courageous decision to release the raw cotton stocks to rescue the external sector objectives of the program, prove the reliability of the authorities' determination for the medium term. But as I noted at the beginning of my statement, their willingness to integrate Pakistan into the world economy faces a major obstacle in the limits imposed by several industrial countries on the importation of Pakistan's competitive exports. The staff could usefully discuss the impact of some specific limits on Pakistan's future export potential, given its existing manufacturing capacity. Are these limits thought to be discouraging to foreign direct investment in the affected sectors?

We believe that, given the great political and economic difficulties that arose during the program period, the authorities have performed well. Although the targets for the correction of the domestic and external imbalances could not be fully met, the authorities' successful implementation of structural reforms encourages our hopes for solid improvement in the future.

We support the proposed decisions.

Mr. Enoch made the following statement:

The Board approved the stand-by arrangement and structural adjustment arrangement for Pakistan almost exactly a year ago. The delay in completing this first review resulted in part from adverse exogenous developments, but also difficulties in monitoring fiscal performance. Therefore, the back-loading of purchases compared to the original programs, and the extension of the programs look to be appropriate.

As the staff report notes, Pakistan has made progress in a number of areas under its adjustment program. Structural reforms have largely complied with the benchmarks, and seem to be gaining some momentum. Reforms have been initiated in the financial sector, and, on the external side, imports are being progressively liberalized, tariff rates rationalized, and inward investment has been made a little easier.

The fiscal revenue target was achieved, although this seems to have been with the support of a number of piecemeal measures. However, the delays in raising administered prices and the reluctance to increase the tax on petroleum are regrettable, and I endorse the staff's exhortations to the authorities to make rapid progress in these areas. I note that the plans for the introduction of the general sales tax seem to be proceeding broadly on their original timetable, and that the authorities referred in their discussions with the staff to the possibility of jeopardizing the implementation of the tax. I hope that this is not a warning about possible delays. I commented last year that the authorities needed to ensure that their tax package would be introduced on the agreed timescale, and I again urge the authorities to ensure that this does not slip. It is regrettable that the date for the achievement of the overall fiscal deficit target of 4.8 percent of GDP has had to be put back by a year.

Clearly, if the revenue effort is constrained by noneconomic factors, restraint on expenditure must be all the greater. The overshooting of expenditure in the past year, and, perhaps, even more important, the pattern of expenditure, give grounds for concern. On the capital side, the involvement of the World Bank in reviews of the public sector investment program gives some reassurance. However, the greatest efforts are required in restraining current expenditure, with particular emphasis on reversing the recent upward trend in subsidy costs. Concentration of subsidies is greatest in the agricultural sector, both directly through input costs and procurement prices, and indirectly through preferential credits. Yet these benefits accrue to a sector where the Central Government is unable to impose direct taxes. The authorities may therefore wish to look at this closely. Other areas of spending which seemed particularly worrying in the past year were general administration and the so-called unallocable element. I would be interested to have the staff indicate what is causing upward trends in these areas.

As the authorities recognize, restrained expenditure may also provide some help to the external position, through compression of government imports. But concern about the balance of payments reaches beyond government expenditure. The deterioration over the past year has been due in large part to a sharp decline in the terms of trade. This brings into focus three interrelated issues that need to be tackled. First, there is a pressing need to diversify exports, both within traditional product groups and into new products. Second, there must be genuine flexibility in exchange rate policy. Third, encouragement must be given to inward investment.

Diversification of exports will depend critically on sustaining competitiveness and allowing the exchange rate to adjust to changing external circumstances. In this context, I note that, despite a decline in the terms of trade of 8 percent over the past fiscal year, the real effective exchange rate declined by less than 2 percent. A more active response to adverse developments may be warranted in the coming year to protect the vulnerable external position. Pakistan's reserves, which were dangerously low at the outset of the program, have not been replenished as programmed, and they are now projected to be essentially no higher even by 1990/91 than they were four years earlier. This must throw into some question the envisaged pace of external adjustment. The cushion provided by the drawdown of cotton stocks this year will not be available again.

Despite this vulnerability, the authorities have continued to maintain a strong record of timely debt servicing; but, as the staff report notes, the slippages this year will have made this somewhat more difficult. I welcome the staff's efforts to improve the quality of Pakistan's debt statistics, as well as statistics on the fiscal side, and I agree with the staff that the authorities need to keep the incurring of further debt obligations under firm control.

I found the appendix to the background paper on foreign direct investment very interesting. Although it was not clear how the comparator countries had been selected, there does seem to be scope for increased inflows to Pakistan. The authorities have recognized this, as is shown by the steps taken to reduce barriers to inward investment and the variety of incentives available. However, I have some doubts as to whether the costs of special incentives are worth incurring. The best incentives are an absence of administrative approval procedures and a sound macroeconomic policy framework, and I urge the authorities to make further efforts in this direction.

The staff papers and the adjustment program place heavy emphasis on the achievement of growth targets, and, indeed, the Pakistan economy has grown strongly over the past year. Such growth is of course welcome, especially in view of the rapid rate of population increase. However, Pakistan has achieved strong growth for several years now, and the genesis of the current programs was a concern that this growth would not be sustainable over the medium term, unless the deteriorating fiscal and external positions were corrected. As I have noted, however, the envisaged improvement in this area has not been forthcoming this year, and the revised program projections involve moving back by 12 months the original timetables for adjustment in these areas. Chart 1 of the staff paper shows clearly how adjustment in the current account and the fiscal position is delayed. The chart shows also, perhaps even more importantly, that the levels of savings and investment are revised downward throughout the program period. Yet the projected growth path from 1990/91 remains unchanged. I would be interested to hear how confident the staff is that the original growth projection can still be achieved, given the deterioration that has occurred in some of the causative factors, and whether the staff thinks that the achievement of this projection under this adverse background might require some acceleration in structural reform and macroeconomic adjustment. In particular, a rapid achievement of a more efficient allocation of credit through a more market-related financial system with realistic interest rates would be helpful; and while I welcome the steps taken to rationalize yields on public sector debt, further and broader progress in the financial area is needed.

In conclusion, I welcome the authorities' commitment to macroeconomic adjustment and to sustained structural reform. I support the proposed decisions, but urge the authorities to be prepared to respond with further adjustment if there were to be further adverse exogenous developments, so that no further extensions of their adjustment program would be necessary.

Mr. Rieffel made the following statement:

My authorities are pleased that, under the medium-term adjustment program launched a year ago, Pakistan has made significant progress in the areas of trade liberalization, tariff rationalization, investment promotion, and credit restraint. Together with a flexible exchange rate policy, these efforts have helped to slow inflation and increase export volumes.

The adjustment path for the first year has been somewhat bumpy, however. In particular, I regret the difficulty encountered in completing the first review under the stand-by arrangement in a timely fashion. Even more important, I regret the decision of the authorities to defer achievement of the original target for the overall fiscal deficit by one year to 1991/92.

The staff report for today's discussion is thorough, perhaps even overwhelming. I will comment on each of the main policy areas.

With regard to fiscal policy, the disappointing outcome for 1988/89 appears to relate primarily to the reluctance to cut subsidies on the expenditure side and to raise taxes on petroleum products on the revenue side. The budget objectives in these areas for the current year are clearly better, but I do not regard them as sufficiently ambitious. As the staff points out, fiscal consolidation is critical to success of Pakistan's adjustment efforts, and--we would add--to achieving more rapid economic growth.

The introduction of the general sales tax in mid-1990 is the keystone of the fiscal effort in the medium term, but it is not a panacea. The coverage of this tax, for example, seems unnecessarily limited: even after the coverage of the sales tax is extended, for the current fiscal year only 32 percent of large-scale industrial production will be covered. The minimal taxation of agricultural production is another serious structural weakness.

The staff noted on page 28 that contingency measures may be warranted to protect fiscal objectives. I fully share this view and would appreciate comments from the staff and Mr. Finaish on what kind of measures would be most effective. When I prepared this statement, I was thinking of contingency measures for adverse developments. The information provided by Mr. Finaish this morning points to the need for contingency measures favorable for developments--such as returning to the original fiscal target.

The staff also hints at a possible threat to fiscal objectives from military expenditures. Given the generally unproductive nature of these expenditures, I agree that this is an area of concern, and the staff should press the authorities to provide more information on these--and any other--nonproductive expenditures.

I would also be interested in knowing whether the problem in pinning down the fiscal outcome for last year, which contributed to the delay in completing the review, has been solved. I hope that this problem will not recur.

With regard to money and credit, we would prefer to see a more front-loaded attack on inflation, given the relatively slow pace of reducing subsidies and removing various price controls.

We continue to view with skepticism the staff's conclusion that Pakistan faces protracted balance of payments problems. In this connection, we are concerned that the target date for achieving a sustainable external position has slipped by a year, just as the fiscal target has slipped. While the terms of trade have had some bearing on this, the leisurely pace of adjustment has been a more important factor.

We are also concerned by the extremely modest target for growth in reserves. This introduces a significant element of risk for the Fund in supporting Pakistan's adjustment efforts. The risk is magnified by the fact that the structural adjustment facility financing is front-loaded. We hope that the authorities would take advantage of favorable trends to raise the reserve target or, even better, forgo further drawings under the stand-by arrangement.

The background paper on recent economic developments in Pakistan contains no data on Pakistan's military debt. In light of recent experience with other countries that have revealed information on unreported debt, the absence of such information places an unreasonable risk on the Fund. I wonder whether a general paper on this subject is not called for.

With regard to structural reforms, we see scope for substantial improvements in four areas. First, administered prices appear to be a serious obstacle to more productive economic activity. Second, while some progress has been made in rationalizing the public enterprise sector, this sector appears to play a larger role in the economy than seems justified. The policy framework paper indicates that "action plans" will be formulated for all public enterprises, but it does not offer any macroeconomic targets for this sector and says very little about privatization. Third, we believe that the economy would benefit substantially from an acceleration of trade liberalization, in particular faster elimination of the restricted list and faster reduction of maximum tariff rates. Fourth, the program of financial sector reform during the next year seems reasonably solid, and we urge authorities to avoid slippages here.

I recognize that developments in the region have contributed to the economic difficulties in Pakistan. Given the difficult circumstances, the authorities have managed quite well, and perhaps even better than expected. I hope that regional developments in future will be more favorable, and that the authorities will take advantage of any opportunities that arise to tap the latent potential for more rapid economic growth.

I support the proposed decisions.

Mr. Ismael made the following statement:

Despite some slippages from the overall fiscal deficit reduction target, and the shortfalls experienced with respect to the programmed external current account deficit and the buildup of gross foreign exchange reserves, Pakistan achieved substantial success in implementing the adjustment program in 1988/89. Most of the qualitative and structural benchmarks and performance criteria established under the program were observed. Major steps were taken in import liberalization and tariff rationalization, and the 1988/89 budget introduced a number of fiscal reforms intended to improve the equity and elasticity of the tax system. The budget also introduced changes in the sales and excise taxes. A number of administered prices were adjusted upward by more than the overall inflation rate, and domestic credit growth was fairly restricted. The rate of price increases generally moderated, as a result of the restrained demand-management policies. Real GDP grew at 5.1 percent, in line with the program target. The exchange rate continued to be managed flexibly.

The fiscal deficit is one of the major areas of concern where slippage was observed in 1988/89. I welcome the intention of the authorities to reduce the budget deficit from 7.3 percent in 1988/89 to 6.3 percent in 1989/90 and further to 5.5 percent in 1990/91. However, the attainment of this objective will depend on the introduction of new revenue and tight expenditure measures. It is regrettable that, despite the new tax and nontax measures introduced in 1989/90, the ratio of total fiscal revenue to GDP is declining from 18.8 percent to 18.3 percent in 1989/90. In this context, the introduction of the VAT-type new general sales tax (GST) system is therefore important. I urge the authorities to introduce the new GET system as early as possible. While the authorities should consider adjusting the administered prices of public enterprises, at least in line with the rate of inflation, they should refrain from any initiatives for tax exemptions.

I agree with the staff that credit restraint must continue to reinforce other adjustment measures. The rate of growth of domestic credit was very low in 1988/89, mainly because of the relatively restrained growth of credit to the private sector.

A somewhat higher rate of growth of bank credit to the private sector is warranted in the years to come. Financial sector reforms initiated during 1988/89 should be continued, with greater emphasis on extension of auctions of treasury bills, and more market-oriented forms of credit control should be introduced.

On external policy, I welcome the authorities' commitment to continue to manage the exchange rate flexibly, with a view to maintaining external competitiveness. This is especially important in view of the need to encourage nontraditional exports and workers' remittances. I note with satisfaction the authorities' desire for trade liberalization and I understand their concern about protectionist measures affecting Pakistan's exports in particular, and developing countries in general.

I noted with concern the multiple currency practice that is now followed in Pakistan. While I am pleased that a firm date has been set to eliminate this practice arising from the minimum mandatory margin requirements for the opening of import letters of credit, I urge the authorities to eliminate this same practice arising from another source--namely, the foreign exchange bearer certificates--as soon as possible.

I endorse the proposed decisions.

Mr. Cirelli made the following statement:

Pakistan's growth performance has been impressive since the beginning of the 1980s, and inflation has been kept under control. However, internal and external imbalances have emerged, owing mainly to lax fiscal policies.

Performance during the first year of the stand-by and structural adjustment arrangements has been mixed: the overall fiscal deficit objective was not fulfilled and the current account deficit further deteriorated; however, given the adverse terms of trade development, the new Administration has taken, in difficult circumstances, the measures needed to avoid a greater deterioration of the situation, and we commend the authorities for this action.

The objectives for next year, however, particularly in the fiscal area, seem somewhat less ambitious than is needed to address the country's present difficulties. During the past few years, the economy's diversification has been somewhat limited, as evidenced by the slow increase of nontraditional exports. In this connection, more resources need to be released to the private sector in order to stimulate domestic savings and private investment. Therefore, there is clearly no room for further slippages if the authorities wish to attain their goals of growth and external equilibrium.

There is a divergence of views between the staff and the authorities on the pace of fiscal adjustment. We share the staff's view that this area constitutes the cornerstone of the whole adjustment process, but it is disappointing that the reduction in the fiscal deficit, although below the initial objective, was achieved through a diminution of development spending, which could endanger growth prospects.

Like Mr. Ismael, we are concerned about the decline in the ratio of fiscal revenue to GDP envisaged in 1989/90, which is due mainly to the lack of adjustment of the surcharge on petroleum products. We urge the authorities to stick firmly to the present objectives for revenues, and in particular to proceed with the introduction of the general sales tax in a timely fashion. This is especially important in view of the need to compensate for the planned reduction in international trade-based taxes. We wish to underscore the necessity to reduce the number of exemptions still in place--which cause economic distortions--and to enlarge as soon as possible the scope of taxation to include the agricultural sector.

On the expenditure side, priority should be given to health and education expenditure. There seems to be more room for restriction of current expenditure--for instance, defense expenditure, which still represents one third of current outlays. We also urge the authorities to keep under review their subsidization policy and the adjustment of public sector prices.

With regard to monetary policy, we commend the authorities for the restrictive stance they have followed so far, which has enabled them to keep inflation under control. We urge them to remain vigilant and keep interest rates positive in real terms, which is highly desirable to stimulate private savings and ensure an adequate allocation of resources. In addition, timely implementation of financial reforms also seems warranted. In particular, moving away from direct credit control to a more market-oriented policy should enhance the efficiency of monetary policy.

I agree with the staff that the exchange rate level should be kept under close review, given the large variations in the terms of trade and the lack of buoyancy of nontraditional exports. However, exchange rate policy cannot be considered as a substitute for the much-needed fiscal adjustment. Furthermore, only the latter can take into account the situation of the population's poorest categories.

Concerning trade reforms, we welcome the steps already taken by the authorities and encourage them to go farther. Indeed, despite a significant reduction in the maximum tariff rate, the actual rate of protection still appears high. It is also of the utmost importance to encourage foreign investment and alleviate the remaining administrative impediments in this area. Furthermore, I agree with the staff that the same regime should be applied for foreign and domestic investors concerning sanctioning limits.

Pakistan's external position will remain fragile, particularly in the wake of the recent slippages. Pakistan will therefore remain dependent on the international financial community. We encourage the authorities to pay close attention to their external debt in order to be in a position to avoid any rescheduling that could bear heavily on Pakistan's future. My authorities are particularly concerned by the recent increase in the ratio of debt to GDP, which will continue in 1989/90. We are fully aware of the difficulties faced by the authorities. We encourage them to pursue actively the implementation of sound economic policies, as they have demonstrated their ability to do. The delay they have requested to attain the program targets is regrettable. We urge the authorities not to relax their efforts.

Mr. Ghasimi made the following statement:

We would like to compliment the authorities in Pakistan for their vigorous efforts and their perseverance in coping with many problems that continue to constrain the performance of the economy.

We are indeed pleased to note that considerable achievements were made in many areas, despite special circumstances faced by the authorities: trade liberalization and investment deregulation expanded, inflationary pressures subsided, control over fiscal operation became firmer, and concrete steps were taken to broaden the tax base and improve the tax administration. Moreover, as the staff papers show, most performance criteria and benchmarks under the first year of the stand-by arrangement and structural adjustment arrangement were met. Although the rate of increase in GDP in 1988/89 at 5.6 percent was below the level of the previous period, it was nevertheless somewhat above the original program target.

We are in broad agreement with the staff appraisal and the staff's proposed corrective measures. We particularly support the staff recommendations on more timely monitoring of revenue and expenditure, debt management, and devoting further efforts to move toward a more market-oriented credit control.

The table of selected economic and financial indicators reveals that, despite determined adjustment efforts by the authorities, the performance of the economy in certain important areas of activities, particularly in the fiscal sector, movements of terms of trade, and the external sector, was rather unsatisfactory.

Notwithstanding considerable efforts aimed at diversification of the economy, Pakistan is still heavily dependent on exports of a limited number of commodities. We are indeed pleased to note, from Mr. Finaish's opening remarks, the rather satisfactory growth of exports of 21 percent achieved during five months of 1989-90. However, the authorities' further efforts to enhance exports would certainly need to be complemented by a reduction in protectionist measures, especially nontariff restrictions, which are estimated to affect nearly 60 percent of Pakistan's exports.

It is clear that, despite some anticipated improvements in the current account, the implementation of the ongoing structural and adjustment reform program must be strengthened through further external financial assistance. Needless to say, the good record of the authorities in program implementation, and the satisfactory qualitative and quantitative results achieved in recent years, all make the extension of further financial assistance to Pakistan quite justifiable. This would certainly enhance the economic growth performance of the country.

Further promotion of foreign direct investment could also be considered complementary to the conventional financial assistance. Although, in recent years, foreign direct investment has accounted for a small share of GDP compared with many other developing countries, implementation of appropriate general macroeconomic policies and adoption of proper industrial policies are among the encouraging factors in attracting foreign investment in productive sectors of the economy.

We note that the overall fiscal deficit has been reduced from 8.6 percent of GDP in 1987/88 to 7.3 percent in 1988/89 and is projected to decline to 6.3 percent in 1989/90. However, as the staff papers show, this declining trend has been achieved partly through a drop in the ratio of development expenditures to GDP. This is indeed most unfortunate. In fact, increases in development expenditures remain the foundation for restructuring the economy and are crucial to meeting Pakistan's need for infrastructure, achieving social objectives, and improving income distribution. It is therefore heartening to note from Mr. Finaish's statement, as well as from the staff's analysis, that current expenditures during 1989-90 are anticipated to fall as a percentage of GDP so as to accommodate some increase in development expenditures.

I support the proposed decisions.

Mr. Noonan made the following statement:

We concur with the staff appraisal and support the modification of the stand-by arrangement and the approval of the second year of the structural adjustment arrangement. For the most part, we believe that the authorities have made significant progress in the past year, both in adopting adjustment measures and in implementing structural reforms. Moreover, this progress was made in the context of maintaining Pakistan's rapid rate of output growth and relatively stable prices. These achievements are well described in both Mr. Finaish's statement and the staff report.

Nonetheless, we regret that a few of the performance targets have been missed. Although these slippages occurred primarily as a result of the substantial deterioration in the terms of trade, the authorities apparently had some scope to take additional measures to contain the slippages. In some ways, the modifications to the program are designed to accommodate, rather than to compensate for, these initial slippages by allowing for a more gradual pace of adjustment.

Like other chairs, we have reservations, particularly about the extent of the accommodation allowed on the fiscal side. The authorities have chosen a more gradual reduction in the fiscal deficit than initially thought to be warranted, and, as a result, Pakistan's external position remains more precarious over the program period. My authorities believe that there is room for further measures on both the expenditure and revenue sides. I note that, although the expenditure target was not met in 1988/89, the authorities aspire in the current fiscal year to reduce expenditure as a share of GDP by more than was initially targeted in the program. My authorities have questioned the feasibility of achieving that aspiration, especially through the imposition of tight ceilings on all major current expenditure categories. Rather, they believe that there will be a greater likelihood of success with, and a better economic case for, curtailing expenditure through the adjustment of administered prices and direct subsidies, such as in the energy and food sectors. There is also room to phase out certain subsidies altogether, such as the subsidies for fertilizers.

We urge the authorities to move away from general price subsidies and toward more focused support for the poorer segments of society. My authorities are concerned about the lack of progress in improving education and health services. In the past, when faced with the need for additional restraints, the burden of adjustment fell disproportionately on the development budget. In our view, more could be done to contain current expenditures and to widen the tax base in order to reduce the extent to which the development allocations have to bear the burden of adjustment.

On the revenue side, my authorities have expressed some exasperation about the projected fall in total fiscal revenue as a share of GDP from 18.1 percent in 1988/89 to 17.5 percent in 1989/90. They believe that such a decline is unwarranted at a time when the present fiscal stance is contributing to a current account deficit that is being met with the assistance of heavy external and concessional support. The argument that raising domestic petroleum prices would jeopardize new tax measures fails to carry conviction. The staff should elaborate on this argument.

While the projections for the external account may turn out to be pessimistic, if the export performance referred to by Mr. Finaish this morning is maintained, due regard must be paid to the fact that it is only by the third year of the program that the current account deficit, as a share of GDP, is projected to reach its 1986/87 level. And, even at that time, the level of reserves is expected to reach only about 8 weeks of imports, a level that in many other countries would give rise to concern. Although this slower path of adjustment reflects, in part, the expectation of continuing adverse terms of trade conditions, it does not leave much room for maneuver in the event of a further deterioration in the external environment. We would therefore prefer to see the authorities aim to return to the original program targets.

Overall, we recognize that, despite slippages, the Pakistan authorities have made significant progress over the past year with their ambitious program. However, there is no room for the authorities to relax their commitment to adjustment and reform.

Mr. Scheid said that the Pakistan authorities had made progress in implementing their ambitious medium-term program of macroeconomic adjustment and structural reform. It was commendable that most of the performance criteria and benchmarks had been met. He welcomed Mr. Finaish's statement underlining the authorities' commitment to continue their adjustment efforts.

But the policy slippages, particularly in the area of fiscal policy, were a cause for concern, Mr. Scheid continued. Although the public sector deficit had been reduced somewhat--unfortunately, primarily at the expense of development spending--the targeted deficit level had not been achieved. It was very regrettable that the return to a more sustainable fiscal position had to be postponed by one year. Public expenditures should be controlled more strictly, and the authorities should be prepared to take further revenue measures if necessary. It was difficult to reconcile the buoyancy of military spending with the obvious need for a genuinely tight fiscal policy.

Budget consolidation was the key to enhancing domestic savings and strengthening the precarious external balance, Mr. Scheid considered. The adverse impact of the terms of trade deterioration on the current account deficit together with an alarming low level of foreign reserves were clear indications of the considerable vulnerability of Pakistan's balance of payments. Even if a more viable current account deficit was reached, presumably one year later than originally envisaged, Pakistan would still be highly dependent on additional financial support from donor countries. That conclusion underlined the need for sustained adjustment efforts with a view to increasing domestic savings and broadening the small export base. On the understanding that Pakistan's authorities would take the necessary steps and avoid further delays and postponements, he supported the proposed decisions.

Mr. Raza made the following statement:

Going through the comprehensive staff review of recent economic developments in Pakistan and Mr. Finaish's informative statement, one is struck by the Pakistani authorities' strong commitment to the wide-ranging--in fact, I must say, sweeping--program of actions embracing practically all aspects of macroeconomic as well as sectoral policies, formulated in consultation with the Fund and the Bank, and their resolve to go ahead with the program despite problems. Given the fact that Pakistan started the programs with an inelastic tax base, weak fiscal control, narrow export base, and rather restrictive trade system, the outcome of the authorities' efforts is indeed impressive.

As was noted by the staff, Mr. Finaish, and many speakers, the agreed program of actions embraced a wide range of actions--tax reform and expenditure restraint, reform of the system of administered prices, better demand management, reform of the financial sector, better and more efficient management of public enterprises, trade and tariff reforms, and exchange rate policy. Actions have already been taken--or, at the least, strong policy actions have been initiated--in pursuit of the agreed structural reforms. As the staff has noted, practically all the quantitative benchmarks have also been observed. The two areas of slippage relate to a considerably lower level of net international reserves and higher than programmed net domestic nonbank borrowing to finance the budget. As regards the first, it may be realized that the level of reserves is the result of changes in other variables--the volume of exports and imports, and the terms of trade--and cannot be affected directly. Therefore, while there is no doubt about the need to build up reserves, I wonder whether it is advisable to include it among the quantitative benchmarks. Pakistan did well on the exports front--in fact, better than envisaged. It was also able to contain imports. And yet, because of the deteriorating terms of trade--a factor that was clearly beyond the control of the authorities--the current account deficit was larger and the level of reserves lower than envisaged. As noted by the staff, the terms of trade deteriorated by over 8 percent during 1988-89 as against by 1.5 percent originally envisaged, causing a loss of an estimated $550 million in the trade balance. In this connection, I wonder whether the staff assumption of a 2.6 percent improvement in the terms of trade in 1989-90 would--or could--be realized.

As to the larger than programmed nonbank financing of the budget deficit, while I agree with the staff on the need to keep expenditure and, therefore, fiscal deficits, in check, I thought that, being noninflationary in nature, recourse to nonbank sources should be preferred. In any event, while agreeing with the need for fiscal discipline, we believe that it is not so much how the resources are raised, but how these are spent, that is especially important and relevant.

Somewhat disquieting features of Pakistan's economy are the rather low savings and investment ratios, although they apparently have not affected the growth of the economy. We would welcome staff comments on this. The staff has indicated that there is some data deficiency. I wonder whether the staff and/or Mr. Finaish could also indicate whether, and to what extent, these ratios are underestimated. However, I am sure that, even if allowance is made for possible underestimation, the ratios would still remain low in relation to the size and the stage of development of Pakistan's economy. This is one area that needs considerable strengthening.

We share the staff's concern about slippages in fiscal policy during 1988-89 and the mounting debt and debt-servicing burden. Like many other Directors, I regret the authorities' reluctance to increase petroleum prices. However, as Mr. Finaish assures us, the authorities are committed to undertaking further fiscal adjustment through enhanced revenue measures, both tax and nontax, and strict expenditure restraint. In this connection, we are particularly happy to note that the authorities intend to rein in current expenditure to permit larger development expenditure in line with the new Government's economic and social objectives.

As to the staff's suggestion regarding agricultural income tax, apart from the associated constitutional, social, and political problems, I wonder whether the agricultural sector in Pakistan is in fact undertaxed, to justify the new imposition. Furthermore, like Mr. Yamazaki, I would also like to know the revenue enhancing effect. In other words, we would welcome staff comments on the justification for an agricultural income tax on equity and revenue consideration involved.

Credit restraint should be a necessary adjunct of the adjustment package. As the staff suggests, growth of the net domestic assets of the banking system should remain below the projected increase in nominal GDP.

We also agree with the staff on the need for diversification of the export base, continued pursuit of a flexible exchange rate policy, and trade liberalization. However, as we have noted on many earlier occasions, trade liberalization is a means to an end rather than an end in itself, and efforts of developing countries in this direction are severely constrained by the attitude of many developed countries.

Pakistan has made sincere efforts to overcome structural bottlenecks. However, as the staff has rightly pointed out, these strong efforts notwithstanding, the country will continue to need substantial additional donor assistance for a number of years to come in order to achieve strong growth performance. I am sure that such assistance will be forthcoming.

In view of the fact that the new Government, with its own socioeconomic philosophy, was installed in office just about a year ago and has already taken strong actions in relevant areas, we strongly support the authorities' requests and the staff's proposal for an extension of the present stand-by arrangement and the proposed purchase under the second annual structural adjustment arrangement.

Mr. Zhang made the following statement:

I am in general agreement with the staff appraisal and support the proposed decisions. The generally satisfactory implementation and performance in 1988/89--the first year of the stand-by and structural adjustment arrangements--fully demonstrated the determination and courage of the Pakistani authorities to persevere with their adjustment efforts. Structural benchmarks were observed in most areas, and all the quantitative performance criteria and qualitative benchmarks for December 1988, March 1989, and June 1989 were met, with the exception of net international reserves in June. Real GDP grew at 5.1 percent, which was in line with the program target, and the rate of price increase was contained to below the Government's 10 percent target. In my view, the overall economic developments in Pakistan are quite impressive, and the authorities should be commended for their remarkable progress.

Nevertheless, the reductions in the fiscal deficit and in the external current account deficit were less satisfactory, as they fell short of the program target, but several positive developments are worth mentioning. First, the financing of the fiscal deficit relied on domestic nonbanking financing, which was larger than envisaged under the program. As a result, bank financing of the fiscal deficit, as well as total credit growth, were less than programmed, which helped to reinforce demand-management policies. Second, total export volume grew by 11 percent, somewhat exceeding the program target in spite of the large deterioration in the external terms of trade--which was the main factor for the widening external deficit. Third, the external debt appeared to be under good control, and debt servicing has been on schedule. This is one of the most important areas and one which will have a decisive effect on the viability of external payments in developing countries. Undoubtedly, these achievements are a positive result of the implementation of the comprehensive program, which includes a series of adjustment and structural reform measures.

I agree that, in the coming year, the budget and balance of payments will still be vulnerable to external developments. There is still much to be done to consolidate what has been achieved and to continue efforts to carry on with the program. Long-term efforts and a commitment in the right direction for adjustment and reform will be needed, even after the end of the program period. The continuity of successful policies is very important. In particular, perseverance of sound demand-management policies and financial discipline should be given high priority, if comprehensive structural reforms are to succeed. In this regard, it is encouraging to note that the Pakistani authorities are firmly committed to continuing their efforts with the support of the Fund.

I also agree with the staff that, given the economic situation in Pakistan, even with strong adjustment and structural reform efforts Pakistan will continue to need substantial additional donor assistance for a number of years so that adjustment and reform can be achieved while permitting the needed strong growth performance. It is apparent that continued assistance from the international community is indispensable to the country.

Mr. Gronn made the following statement:

I commend the authorities for the satisfactory implementation of a number of policy measures in the first year of an ambitious economic adjustment program under the stand-by and structural adjustment arrangements. These include trade liberalization, external tariff reform, investment, and industrial deregulation. The economy suffered, however, from a deterioration in the terms of trade in 1988/89, resulting in a weakening of the external accounts.

When looking at macroeconomic indicators of the Pakistani economy, one gets the impression that the general direction of adjustment has been correct, but insufficient to generate the expected developments in the fiscal deficit, the current account, and international reserves. Therefore, the adjustment efforts need to be reinforced.

I broadly agree with the staff appraisal and will comment on fiscal and industrial policies and the role of tax exemptions.

As is noted by the staff, slippages occurred in the fiscal policy area in 1988/89, as subsidy outlays exceeded expectations. However, the larger than anticipated share of domestic nonbank financing of the deficit, through large sales of bonds, was a welcome feature. Nevertheless, in the future, strict adherence to the deficit reduction strategy will be necessary in order to attain external viability.

According to the staff's projected external outlook, the foreign debt/GDP ratio will remain high, and the debt service ratio will shrink only marginally to the year 1991/92. Fiscal deficit reduction and structural fiscal reform will definitely play key roles in achieving progress in this area and in the successful implementation of the program supported by the structural adjustment arrangement.

Last year, this chair expressed concern about the distortionary effects caused by the existing tax immunities and exemptions. This concern remains, and the authorities are confronted with a difficult balancing act in scaling down these arrangements: on the one hand, they need to reduce the budget deficit; and, on the other hand, investments need to be increased and improved and the export base needs to be widened. The budget deficit should be reduced through not only expenditure restraint but also revenue measures. I welcome the authorities' plan to continue to broaden the tax base, as this seems to be necessary in light of the projected decline in the revenue/GDP ratio.

The new industrial policy presented in July--which includes, among other things, an increase in the sanctioning limit for new investment and simplification of the sanctioning procedure--is a welcome part of the efforts to increase productive investment. However, in looking at the measures to support these industrial initiatives, I am struck by the extensive use of tax exemptions to promote new investment. In less developed regions, exemptions will cover income taxes, import surcharges, customs duties, and sales taxes. Moreover, to encourage foreign investment, the Government recently reinforced an incentives package and extended the tax holiday to the year 2000. These incentives obviously attract capital to the targeted areas, but it is questionable whether this results in an efficient allocation of resources. These incentives will certainly have adverse effects on fiscal revenues.

The revised policy framework paper includes the authorities' general commitment to improving direct taxation through the elimination of immunities and exemptions. However, the economic policy memorandum is explicit only about the removal of preferential exemptions and concessions on customs duties. The extent of the remaining exemptions seems to be larger than desirable when one takes into account the distortionary effects on both government revenues and resource allocation. Therefore, I urge the authorities to step up efforts to remove these tax exemptions. The staff should comment on the appropriateness of the present scope of tax exemptions.

I support the proposed decisions.

Mr. Marino commended the authorities for the notable progress made in adopting structural reforms and adjustment measures despite the adverse external developments, the unfavorable climatic conditions, and the civil disturbances during the last two years. The progress made in the areas of trade liberalization, fiscal reform, investment, and industrial deregulation would lay the basis for a more competitive and efficient economy. Some of the benefits of those reforms were already manifest in the stronger than anticipated levels of private sector capital formation and real GDP growth, while the rate of inflation had remained low.

He welcomed the authorities' commitment to persevere with their adjustment effort and to continue giving an outward orientation to their economy, Mr. Marino said. He hoped that in the coming years Pakistan's main trading partners would not intensify the protectionist measures that so greatly affected Pakistan's traditional exports. Pakistan's vulnerable external position would strengthen as long as the authorities adhered to a flexible exchange rate policy that allowed the share of nontraditional exports to expand and provided that the external environment they faced was receptive to their products.

As Mr. Finaish had highlighted in his opening statement, fiscal reform was the cornerstone of the adjustment program in Pakistan, Mr. Marino commented. Therefore, the authorities should take all the necessary measures to achieve the reduction in the fiscal deficit contemplated in the program. Slippages could not be tolerated in that area.

He welcomed the authorities' intention to adopt measures that would expand the tax revenue base and increase the equity of the tax system, Mr. Marino said. Regarding the proposed increase in the price of petroleum to enhance fiscal revenues, he, like other Directors, agreed with the authorities that great care should be exercised when using those types of measures, since their influence on the price level through their effect on costs could jeopardize other objectives of the program. In general, administered prices should be guided by resource allocation considerations rather than by fiscal considerations.

He supported the proposed decisions, Mr. Marino concluded.

Mr. Hogeweg said that he supported the staff appraisal and the proposed decisions and welcomed the fact that it had been possible to agree on an adjustment path in response to the developments that had occurred, especially the adverse movements of the terms of trade.

The performance criterion on the real effective exchange rate had been adapted to maintain the present depreciated level, Mr. Hogeweg noted. He fully understood the emphasis on the competitive position in view of the adverse terms of trade movement, but he had also noted the stretching of the pace of fiscal adjustment, and he fully agreed with Mr. Cirelli that nominal depreciation should not be a substitute for fiscal adjustment. Focusing on the effective exchange rate in that way did of course mean that there was no role at all for the exchange rate as a nominal anchor and no incentive from that side to adjust domestic costs to maintain competitiveness. He wondered how the staff judged the mix of nominal exchange rate depreciation and domestic efforts as envisaged in the program. In addition, the staff could usefully discuss whether the role of the real effective exchange rate in the program influenced the foreign exchange market through increased predictability of the authorities' actions to adjust the nominal exchange rate in response to cost differentials.

Mr. Monyake said that he supported the proposed decisions. The authorities were to be commended. They faced significant internal and external political constraints, including natural disasters, a security situation that was not very conducive to good economic performance, and a flood of refugees into the country. Nevertheless, the staff report showed that they had on the whole performed very well. The Board should look at the whole package and recognize the various achievements, and, while indicating the occasional shortcomings, encourage the authorities to improve their performance.

The question of the prices of petroleum products and their impact on other prices and on the cost of living had usefully been raised by Mr. Iqbal, Mr. Monyake said. Careful consideration should also be given to the optimum package of revenue-raising measures that should be recommended by the Fund. Some measures might create problems; an agricultural tax could yield considerable revenue but the impact on the cost of food for the population must be considered.

Pakistan needed the support of the donor community for the adjustment program, Mr. Monyake said. Lack of such financing sometimes led to programs falling short of expected targets.

The Director of the Middle Eastern Department stated that there had clearly been some slippage in the fiscal area. It should be emphasized that one of the most important program objectives was to increase the elasticity of the tax system. It had been felt that achievement of that objective could be jeopardized if an attempt were made to increase tax yields too quickly in order to meet a fiscal target for a particular year. That conclusion was particularly applicable when the difficulty in and timing of increasing petroleum product prices was taken into account. In 1988/89 and in 1989/90, the sales tax base had been extended substantially, from 22 percent to 32 percent of large-scale manufacturing production, and the increase in yields had been most encouraging. In addition, a kind of value-added general tax was to be introduced in July 1990--the beginning of the new fiscal year--which would of course imply a significant change in the administration of the sales tax system. Moreover, the authorities had commissioned foreign consultants to examine the direct tax system and to prepare recommendations for implementation in 1990/91. The staff considered that the tax incentives for new industries--both foreign and domestic--were excessive and created distortions. The staff felt strongly that creating the proper macroeconomic environment--including, inter alia, a relatively stable but realistic exchange rate--through policies conducive to enhanced investment, was much more important than administrative tax incentives that could distort the pattern of investment and even discourage investment and thus lead to a loss of revenue.

The Constitution placed the taxation of the agricultural sector under the sole purview of the provincial governments, the Director explained. In the circumstances, the steps that the Government had taken were significant: nonobligatory transfers from the Central Government to the provinces had been cut in order to put pressure on the provincial governments to take action particularly in the area of agricultural taxation. However, taxation of the agricultural sector was a politically sensitive issue in Pakistan; and, therefore, the staff could not say with any certainty whether or not the Government's move would be very effective. It was difficult to estimate the likely yields from a tax on agriculture, although it seemed fairly clear that that sector was undertaxed. The precise amount of the yield of a tax on agriculture would depend on the level of holdings of agricultural land that would be exempted and the rate of the tax applied.

The real effective exchange rate had depreciated by 9 percent by mid-December 1989, compared with the average rate in the period April-June 1988, the Director said. While there could be no disagreement on the need to foster international competitiveness, it was also necessary to improve domestic price performance; and in managing the exchange rate, one must be clear whether the rate one had in mind was the nominal or the real effective exchange rate.

The authorities had recently indicated to the staff that the preparations for introducing the general sales tax on July 1, 1990 were on track, the Director commented. The relevant legislation was to be presented to the General Assembly in January 1990. The administrative aspects of the implementation were well under way, including training of personnel, registration of taxpayers, and development of a computer system. At present, the target date of July 1 still seemed feasible.

In assessing reasons for the increase in the general administrative category of government expenditures and in unallocable expenditures in 1988/89, followed by the projected decline in 1989/90--as noted by Mr. Enoch--the Director said, it was useful to bear in mind that, for the time being, the federal expenditure data for 1988/89 were highly tentative. The staff had emphasized to the authorities the need to improve expenditure monitoring, and the staff planned to provide technical assistance in that area in early 1990. The authorities had stated that the general administration federal expenditures had probably been overstated in 1988/89, owing to the possible misclassification of the relief measures in the budget for that year; in the past, relief measures had been included among administrative expenditures. In the future, those measures would be assigned to a more appropriate budget category. In addition, apparently some of the expenditures associated with the elections in late 1988 were included among the general administration expenditures; if there were no additional elections in 1989/90, that particular expenditure would not recur in that year. As to the category of unallocable expenditures, reliable expenditure data in Pakistan were usually available only with a lag of approximately nine to ten months from the end of the fiscal year. The staff estimated federal expenditure from the financing side; it did not yet have the provisional actual data for 1988/89. As a result of using that procedure, available budget estimates included a large unallocable component. Subsequent revisions of those data would of course allocate expenditures under the unallocable category to appropriate specific categories.

The authorities remained committed to divesting certain public sector enterprises, the Director commented. However, that commitment had been on the record for a number of years, and thus far little had actually been accomplished in that area. Still, the authorities had indicated that, in 1989/90, they would begin the sale of shares in 14 companies that had been identified in an action plan that had been completed in August 1989. The IFC was assisting the authorities in that area, and privatization would probably involve the cement, rail, and energy industries.

The capital markets in Pakistan were not sufficiently developed, the Director noted. However, steps in that direction had been taken with the creation of a number of financial institutions that had previously not been permitted to exist in Pakistan.

The staff attached considerable importance to export diversification in Pakistan, the Director said. As speakers had noted, Pakistan, like many other developing countries, had suffered from protectionist measures imposed abroad. There was scope for increased exports of manufactures of medical instruments, as well as cotton goods, as long as Pakistan did not reach the ceiling under the international fiber agreement. It was difficult to predict how exports would react once the appropriate macroeconomic framework was in place; the potential to increase exports existed, but it was difficult to know in advance which particular items were likely to increase.

Subsidies, particularly on wheat and fertilizers, had been increasing, the Director observed. The fertilizer subsidy was being phased out in accordance with an agreement with the World Bank for an agricultural structural adjustment loan. The subsidies on wheat--especially wheat flour--had been retained, for social reasons, but the authorities planned to increase the issue price of wheat in March or April 1990.

The staff had projected a 2 1/2 percent improvement in the terms of trade in 1988/89, the Director remarked. That improvement was accounted for by the expected 5.9 percent increase in the price of cotton manufactures. At present, the projected increase in the terms of trade seemed likely to materialize.

The staff did not have data on the stock of military debt/expenditure in Pakistan, the Director said. Moreover, the staff did have a debt-servicing schedule up to the year 2000; the schedule was on a rolling basis, and any change in the data triggered discussions between the staff and the authorities.

The appropriate mix of emphasis on nominal exchange rate adjustment and fiscal adjustment had been queried by Mr. Hogeweg, the Director of the Middle Eastern Department recalled. The weight of the evidence clearly pointed to the desirability of a larger fiscal adjustment effort rather than a depreciation of the nominal exchange rate. Experience suggested that, in the absence of adequate fiscal adjustment, the economy could fall into a vicious circle of high rates of inflation, exchange rate depreciation, and still higher rates of inflation. The business community and the general public attached considerable importance to maintaining a relatively stable exchange rate; to that end, it was imperative to address the underlying problems facing the economy. The amount of the needed fiscal adjustment was not in excess of the amount that the authorities planned under the program for 1989/90. Indeed, as one speaker had stressed, trying to increase revenues in relation to GDP beyond a certain point could jeopardize the achievement of a lasting solution to the fiscal problems, which were structural in nature. If the authorities aimed to achieve the targeted fiscal adjustment, even with a year's delay, and if there were no unexpected adverse developments, the adjustment mix should be appropriate.

The staff representative from the Middle Eastern Department noted that, while several speakers had indicated their concern that petroleum prices in Pakistan should not be raised simply to increase revenues for the budget, some other speakers had said that it was regrettable that the prices had not been increased in 1989. The authorities set domestic petroleum product prices administratively. Those prices were of course higher than import prices, and the difference between the import cost and the domestic price accrued to the government as a kind of floating excise tax that was referred to as the development surcharge. In the past several years, domestic petroleum product prices in Pakistan had not been reduced, even though petroleum prices in international markets had generally been weak; as a result, there had been a gradual increase in the rate of excise taxation on petroleum products in Pakistan. However, in the current fiscal year, it was expected that average petroleum import prices would be higher than in the previous fiscal year, and, therefore, if domestic petroleum product prices were not adjusted in the current year, the rate of excise taxation would decline; that was one of the main reasons why the ratio of government revenue to GDP was projected to be lower in the current year after the healthy increase in the previous year. The staff had felt that a sharp reduction in the rate of excise taxation on petroleum products raised questions of resource allocation--as well as revenue questions--and was therefore an important issue. The authorities would likely acknowledge that there was a resource allocation question involved, but they had decided not to adjust the prices for the reasons that Mr. Finaish had described in his opening statement.

The importance of adhering to the original 1989/90 program targets for the monetary aggregates and domestic credit had been stressed by Mr. Yamazaki, the staff representative remarked. At present, the rate of growth of net domestic assets for program purposes was only slightly greater than the original program target. However, that rate of growth was much lower than the programmed rate for 1988/89. Therefore, the stocks of net domestic assets and of domestic liquidity were projected to be significantly smaller at the end of 1989/90 than they would have been under the original program. That was part of the authorities' response to the adverse external conditions that they had faced in 1988/89.

Another question that had been asked was whether the problem of pinning down the exact size of the fiscal deficit had been solved, so that it would not become an issue that might delay a future review, the staff representative remarked. Monitoring fiscal developments--especially expenditure--in Pakistan was difficult but also very important under the present program. The specific issues that had caused the delay in the current review had been resolved; those issues had centered on the timing of the credit to the budgetary accounts for large external aid flows related to wheat that had been provided late in the year.

As to the general question of saving and investment rates and the projected rate of growth under the program, the staff representative from the Middle Eastern Department noted that the program had anticipated that, as fiscal adjustment was initiated, there would be some decline in private saving in the first year of the program but it had been larger than expected because of the substantial terms of trade shock that had occurred. However, that decline was still much smaller than it had been in 1988/89. The staff felt that, given the ongoing financial reform and the projected depressed but relatively stable terms of trade, the private saving performance was likely to improve over the rest of the program period. Aggregate investment had been slightly lower than had been programmed mainly because of the apparent need to restrain development spending during the first year of the program in order to achieve the desired fiscal adjustment. That step had been taken by the authorities in close consultation with the World Bank to ensure that the cuts in development spending would have a minimal effect on ongoing projects; and, in fact, private sector investment had responded well. In the circumstances, the staff felt that, if the projected increases in investment did take place over the program period, there should be no reason why the target growth rate under the program could not be attained.

Mr. Iqbal said that it was still not clear to him how oil pricing policy in Pakistan affected resource allocation. After all, domestic oil product prices in Pakistan continued to be above world market prices. Another issue was the effects of oil pricing policy on competitiveness, growth, and economic development, especially of transportation, agriculture, and processing industries, which could over time be a much better source of revenue than the current domestic petroleum taxes.

The staff representative from the Middle Eastern Department remarked that most countries had excise taxes on petroleum. The staff had compared the level of Pakistan's excise taxes with the level in a number of other countries: Pakistan's were higher than some and lower than others. The point about resource allocation was important: in recent years, on the basis of the excise taxation rates and real petroleum prices, important production and consumption decisions had been made by the private sector in Pakistan about the use of petroleum products as inputs into the productive process and in final consumption. If the domestic prices were not adjusted in 1989/90, the rate of excise taxation would decline, with substantial effects on resource allocation.

Mr. Iqbal commented that it might be more useful, from an analytical viewpoint, to look at the prices prevailing in Pakistan's competitors in assessing Pakistan's competitiveness.

The Acting Chairman remarked that exchange rate policy and fiscal policy appeared to be mutually complementary, rather than substitutes for one another. An objective of reducing the fiscal deficit was to free resources and increase overall domestic savings to permit external adjustment to take place. That process might have to include a decline in the exchange rate, in which event the exchange rate adjustment would be a complement to the fiscal adjustment and not a substitute for it.

The Director of the Middle Eastern Department said that he agreed that the exchange rate and fiscal policies complemented one another and were not substitutes. In a situation in which the exchange system was free and there were large budget deficits, the staff would hesitate to begin addressing the exchange rate policy before addressing the fiscal policy; experience showed that failure to do so could create problems in an economy.

Mr. Enoch commented that much would depend on the nature of the shock at a time when a country was making a fiscal adjustment effort.

The Director of the Middle Eastern Department said that he agreed with Mr. Enoch. If the fiscal deficit were being gradually reduced, but there was a major shock from the external side--say, a major cut in the price of cotton--then the presumption must be that a correction would be needed on the external side. In that event, an exchange rate depreciation might be in order.

The staff representative from the Middle Eastern Department noted that, in the period after the terms of trade shock had been recognized, there had been a rapid depreciation of the real exchange rate combined with continued very tight restraint of the growth of net domestic assets relative to what had been foreseen in the program. That response was in the right direction, given the nature of the shock--an exogenous external development.

Mr. Rieffel remarked that Mr. Finaish had suggested that the rate of inflation for the current fiscal year was of the order of 6 percent. He wondered whether it was felt that that rate could be sustained through the whole year.

Mr. Finaish said that, while acknowledging that there had been some shortfalls in program implementation--which was, perhaps, inevitable in a program as comprehensive and complex as the one being implemented by Pakistan--it was important to recognize that substantial progress had been made. The Government had demonstrated its willingness to undertake difficult measures across a broad front despite unsupportive external and internal circumstances. Pakistan's program was ambitious and comprehensive by normal Fund standards, and disproportionate importance should not be attached to program slippages.

His authorities would continue to pursue pragmatic and prudent policies to ensure high growth rates and financial stability, so that the efficiency and competitiveness of the economy would be strengthened, Mr. Finaish remarked. They remained firmly committed to implementing the program with the Fund and looked to the continued support of the international community as an important complement to their own efforts to enhance savings and investment and to address the urgent socioeconomic problems facing the country.

The staff report recognized that an agricultural income tax was a complex and delicate issue involving constitutional matters and difficult administrative problems, Mr. Finaish commented. Under the Constitution, an agriculture income tax was not within the purview of the Federal Government and would thus require the concurrence of all four provincial governments. However, the 1988/89 budget added agricultural income to nonagricultural income to determine the applicable marginal tax rate, an important step toward reducing tax evasion. Despite the sensitivity of the matter, the authorities remained committed to extending the scope of taxation in the agriculture sector at the earliest feasible date. A Cabinet subcommittee had been set up to review the matter, and a decision on action in that area was expected soon.

It was useful to note that a major impediment to privatization had been removed with the passage of the Presidential Ordinance of August 3, 1988, and the authorities had reiterated their commitment to divest partially or fully certain public enterprises, Mr. Finaish said. A Privatization Committee has been set up in September 1989, and a leading U.K.-based investment bank and the IFC were assisting the authorities in that task. In the current year, in the first of a series of privatization actions, the Government expected to sell shares of a major gas distribution company. The authorities would also formulate a timetable for the gradual sale of shares of the nationalized commercial banks.

Pakistan maintained a liberal environment for foreign private investment, including full repatriation of capital, dividends, and profits related to foreign direct investment, Mr. Finaish noted. Six new private investment companies, some of which involved foreign investment, had been sanctioned and were to be set up. Applications to set up subsidiaries of foreign banks were under review, and one application had been approved. Negotiations for a $1 billion thermal power plant in the private sector, the first of its kind, were nearing completion. The Government of Pakistan remained committed to a policy of progressively expanding the role of the private sector so as to allow it to play an increasingly important role in economic development.

The treatment of military debt should be uniform across all countries, Mr. Finaish considered. The present staff report on Pakistan was more explicit than usual. Pakistan would like to further restrain defense spending if the regional security situation improved and its neighbors did the same. In any event, the Government had taken strong measures to contain the growth of defense expenditures. Under the 1988/89 budget, defense spending had risen by a nominal 3.7 percent, which represented a severe cut in real terms. For the period 1989-91, it was expected that those expenditures would be further limited to no more than 5.9 percent of GDP. That strict ceiling on defense expenditures, supplemented by other measures to constrain current spending, had allowed the authorities to redirect resources toward meeting urgent social and development goals.

The Acting Chairman made the following summing up:

Directors were in general agreement with the thrust of the appraisal in the staff report on the 1989 Article IV consultation with Pakistan, noting with satisfaction that implementation of the program in 1988/89 was broadly as envisaged in most areas. They commended the authorities for taking further measures to keep the program on track during 1988/89, when a large unanticipated deterioration in the external terms of trade emerged. However, Directors observed that the reduction in the overall fiscal deficit had been less than programmed and gross official reserves had remained uncomfortably low.

In light of strong adverse exogenous factors, including a difficult social, security, and political environment, several Directors sympathized with the authorities' decision to achieve the macroeconomic objectives of the program one year later than originally envisaged--that is to say, by 1992. Most Directors, however, regretted that the revised medium-term program for 1989/90 and 1991/92 entailed a slower pace of fiscal and external adjustment, stressing in this context that strengthened fiscal discipline and external adjustment were critical prerequisites for satisfactory economic growth, social development, and further trade liberalization.

In the fiscal field, speakers noted with concern the decline in the ratio of fiscal revenue to GDP budgeted for the current fiscal year. They urged the authorities to adhere strictly to continued structural fiscal reform, including their commitment to introduce the general sales tax as scheduled on July 1, 1990. They also urged additional fiscal measures, including income tax reform and meaningful steps to extend taxation to the agricultural sector. Directors underscored the need for early adjustment in key administered prices. Noting in particular that revenue from the surcharge on petroleum products was projected to decline markedly in 1989/90, most Directors favored early enhancement in the domestic prices of petroleum products. A few Directors, however, questioned that view on grounds of resource allocation, since domestic petroleum prices in Pakistan were higher than those prevailing in international markets.

While they welcomed the authorities' efforts at redirecting spending toward high priority sectors such as education and health, Directors strongly encouraged further efforts to limit unproductive spending and subsidies. Given the very tight expenditure ceilings and ambitious revenue targets, Directors reiterated the need for strict expenditure discipline and monitoring, as well as for readily available fiscal contingency measures that would facilitate prompt corrective action, if needed. Efforts to enhance the financial performance of public sector enterprises should also be pursued vigorously, and Directors hoped that, as planned, the privatization program would soon gain momentum.

Directors welcomed the authorities' determination to persevere with firm domestic credit restraint, which was viewed as necessary to help achieve the inflation and external targets. Because of the enhanced role to be played by the private sector, it was considered that progress should be made in reducing the overall fiscal deficit in order not to crowd out private sector access to credit. Noting the initial steps to reform the financial sector, Directors urged the authorities to act forcefully to enhance competition in financial intermediation and to develop market-oriented techniques of domestic credit allocation and overall credit management. They also emphasized the need to strengthen the financial position of the banking system and to foster the generation and mobilization of savings. These reforms, together with further deregulation of the economy, enhanced public savings, and continued adjustments in domestic costs and prices, were essential for raising investment and ensuring a more sustainable growth path over the medium term.

Directors commended the authorities for following an exchange rate policy geared toward ensuring external competitiveness. However, Directors viewed such a policy as needing the support of appropriately tight macroeconomic policies as well as continued structural reforms in order to stimulate traditional as well as nontraditional exports.

Directors commended the authorities for their commitment to continue trade reform and further industrial deregulation despite difficult economic circumstances, and encouraged them to pursue reform in these two areas in subsequent years. While a few Directors noted that the level of protection afforded to industry continued to be relatively high, Directors generally urged the authorities to continue reducing import restrictions, including further limitations on the negative import list, and also to take further steps to reduce tariffs. A number of Directors, however, recorded their concern about the protectionist pressures abroad against Pakistan's exports. Several Directors also considered that income tax and customs duty exemptions should be reduced.

Given the large debt service burden and the fragile balance of payments position, Directors stressed that Pakistan would continue to need substantial concessional donor assistance for the years to come and considered continued adherence to a very cautious foreign borrowing policy and efforts to foster nondebt-creating capital inflows to be important. A number of Directors also advocated that the authorities should take further steps to create an environment that would be conducive to greater foreign direct investment in Pakistan.

In conclusion, Directors welcomed Pakistan's determination to pursue growth-oriented adjustment and fundamental structural reform, adding that there was clearly no room for relaxation of the commitment to reform, and that continued financial discipline and further structural reform measures were likely to be required if not during, then certainly after, the completion of the program in 1991/92.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Pakistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1989 Article XIV consultation with Pakistan, in the light of the 1989 Article IV consultation with Pakistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Pakistan maintains a number of restrictions on the making of payments and transfers for current international transactions as discussed in EBS/89/228. These are maintained in accordance with the transitional arrangements of Article XIV, except for the restriction evidenced by bilateral payments agreements with Fund members, mandatory minimum margin requirements for opening import letters of credit, and the system of Foreign Exchange Bearer Certificates. The latter two measures also give rise to multiple currency practices that are subject to approval under Article VIII. The Fund welcomes the authorities' intention to

eliminate by June 30, 1990 the mandatory minimum margin requirements for opening import letters of credit. In view of this intention, the Fund grants approval for the retention of this restriction until June 30, 1990, or the completion of the second review under the stand-by arrangement for Pakistan, whichever is earlier.

Decision No. 9332-(89/168), adopted
December 22, 1989

Review Under Stand-By Arrangement

1. Pakistan has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement (EBS/88/250, Sup. 3, 12/30/88) and paragraphs 32 and 33 of the letter of intent (Memorandum on Economic Policy of the Pakistan Government) dated November 15, 1988 from the Minister of Commerce, Finance, and Planning and Development, and the Governor of the State Bank of Pakistan (EBS/88/232, 11/15/88), in order to (1) review the progress made in implementing the policies described in the letter; (2) complete the first review and reach understandings with the Fund regarding the circumstances in which purchases can be resumed under the arrangement; and (3) reach understandings on the extension of the period of the stand-by arrangement until June 30, 1990 and on suitable performance criteria for end-December 1989 and end-March 1990.

2. The letter of intent (Memorandum on Economic Policy of the Pakistan Government) with attached Tables 1, 2, 3, and 4, dated November 30, 1989 from the Advisor to the Prime Minister on Finance, Economic Affairs, Planning, and Development and the Acting Governor of the State Bank of Pakistan shall be annexed to the stand-by arrangement for Pakistan, and the letter of intent (Memorandum on Economic Policy of the Pakistan Government) dated November 15, 1988 from the Minister of Commerce, Finance, Planning and Development, and the Governor of the State Bank of Pakistan shall be read as supplemented and modified by the letter of intent of November 30, 1989.

3. Accordingly, the limits, targets, and the intentions on exchange rate measures specified in paragraphs 4(a) and (d)(i) of the stand-by arrangement shall be amended as specified in Table 9 of EBS/89/228 and paragraphs 22, 27, 29, and 33 of the letter of intent, dated November 30, 1989, and Tables 1, 2, and 3 attached thereto (Attachment I).

4. Paragraphs 1, 2, and 4(c) of the stand-by arrangement shall be amended to read as follows:

1. For the period from December 28, 1988 to June 30, 1990 Pakistan will have the right to make purchases from the Fund in an amount equivalent to SDR 273.15 million, subject to paragraphs 2, 3, 4, 5, and 6 below, without further review by the Fund.

2.(a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 142.04 million until February 28, 1989, the equivalent of SDR 168.26 million until May 15, 1989, the equivalent of SDR 194.48 million until March 15, 1990, and the equivalent of SDR 220.70 million until May 31, 1990.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Pakistan's currency in the credit tranches beyond 25 percent of quota.

4.(c) During any period after May 31, 1990 until the second review contemplated in paragraphs 33 and 37 of the Memorandum on Economic Policy of the Pakistan Government dated November 30, 1989 (Attachment I) has been completed, and any understandings deemed to be necessary by the Fund have been reached, or after such understandings have been reached, while they are not being observed.

5. The Fund decides that the first review contemplated in paragraph 4(b) of the stand-by arrangement has been completed, and Pakistan may proceed to make purchases under the stand-by arrangement.

Decision No. 9333-(89/168), adopted
December 22, 1989

Structural Adjustment Facility - Second Annual Arrangement

1. The Government of Pakistan has requested the second 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 first annual arrangement, and notes the revised and updated policy framework paper contained in EBD/89/376.

3. The Fund approves the arrangement set forth in EBS/89/228, Supplement 2.

Decision No. 9334-(89/168), adopted
December 22, 1989

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/89/167 (12/20/89) and EBM/89/168 (12/22/89).

2. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/89/303 (12/19/89) is approved.

APPROVED: August 30, 1990

LEO VAN HOUTVEN
Secretary